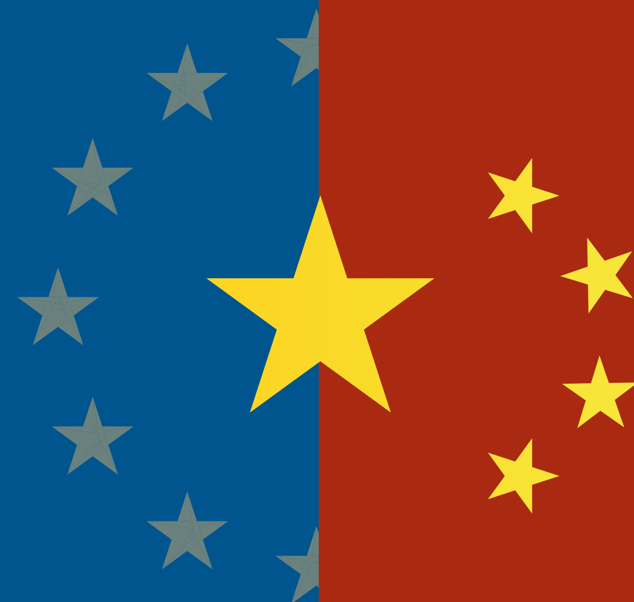
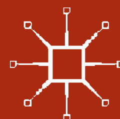
# The Politics of EU-China Economic Relations

## An Uneasy Partnership



John Farnell and
Paul Irwin Crookes



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John Farnell • Paul Irwin Crookes

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John Farnell
Paul Irwin Crookes
Oxford, December 2015

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# List of Abbreviations

| | |
|---|---|
| ADA | Anti-Dumping Agreement (WTO) |
| ASCM | Agreement on Subsidies and Countervailing Measures (WTO) |
| AIIB | Asia Infrastructure Investment Bank |
| CASS | Chinese Academy of Social Sciences |
| CCP | Chinese Communist Party |
| DG | Directorate-General (of the European Commission) |
| ECB | European Central Bank |
| EEAS | European External Action Service |
| EFSI | European Fund for Strategic Investment |
| FDI | Foreign direct investment |
| GDP | Gross domestic product |
| IMF | International Monetary Fund |
| IPR | Intellectual property rights |
| MES | Market Economy Status |
| NDRC | National Development and Restructuring Commission |
| OECD | Organisation for Economic Cooperation and Development |
| PBoC | People's Bank of China |
| PCA | Partnership and Cooperation Agreement (between the EU and China) |
| RMB | renminbi |
| SDR | Special Drawing Right (of the IMF) |
| SOE | State-owned enterprise |
| TPP | Transpacific Partnership |
| TTIP | Transatlantic Trade and Investment Partnership |
| UNCTAD | United Nations Conference on Trade and Development |
| WEF | World Economic Forum |
| WIPO | World Intellectual Property Organisation |
| WTO | World Trade Organisation |

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PART I

# EU–China Relations in a Global Context

CHAPTER 1

# A New Economic Relationship in a Changing World

Two of the three largest economies in the world, China and the EU, are rethinking their economic relationship, after decades of moving closer together. The future direction of that relationship will have major implications for the world economy, not only for China and Europe.

The last two decades have seen an extraordinary change in the economic weight and prospects of the EU and China. The EU has experienced steady erosion of its global economic importance and its self-confidence as an economic and political entity. China, by contrast, has taken a more commanding position on the world stage, as an economy set to rival that of the USA within the next ten years and as a political and military power determined to assert its interests within Asia and beyond. The Chinese and European economies have become interdependent since China's re-emergence, and in some areas, interdependence is still increasing. The political mood of the China–EU relationship, however, has changed. The EU's original vision of itself as a missionary for open markets and democratic political systems addressing a China ready to listen to its advice has lost all credibility. Meanwhile, China has become more active in promoting new international economic institutions and alternative economic models to those of the developed world.

During this period of change, the EU and China have sought to enhance their economic and political relations. In 2003, they committed themselves to developing a Comprehensive Strategic Partnership, in which they would not only seek to improve their already close economic ties but

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also consult on political and security issues and cooperate across a wide spectrum of common interests, ranging from research and education to environmental issues to "people-to-people" dialogue. Twelve years later, it is widely acknowledged (if not yet officially) that the results of the Strategic Partnership have been disappointing. Whilst contacts between the two sides continue to multiply, there has been little fundamental change in the structure of their economic relationship, which many in Europe see as "one-sided," and no major policy decision by either side that has offered the prospect of such change. More frequent dialogue may have increased mutual understanding, but no major step towards genuine mutuality and cooperation has been taken that goes beyond multilateral commitments. Economic exchanges are no longer growing at the hectic pace of the first decade of this century, and attempts to extend China–EU cooperation into new areas have so far failed to show results. Today's debate within a number of EU Member States about the potential risks of allowing Chinese direct investment to increase, when an overall increase in infrastructure investment is badly needed, illustrates that, for many people in Europe, China is different.

This book examines the political factors within the EU and China that may explain the apparent stalling of the EU–China Strategic Partnership in economic terms, and offers a more realistic prognosis of how the relationship might develop over the coming years than can be obtained from official communications.

As the following chapters show, the background conditions for close cooperation and productive interchange between China and the EU are favourable in many respects. The economic challenges facing both economies are similar: a deficiency of natural resources, an ageing labour force, pressure for industrial restructuring, and the creation of new jobs through innovation. Each side's economic policy goals, whether defined in Five-Year Plans or the EU's 2020 Agenda, contain similar commitments to promote innovation in knowledge-based industries, to ensure environmental sustainability, to improve education, and to deliver cost-effective health services and social protection. The two sides speak the same policy language, at least on the surface.

They also have complementary assets. Europe has technological and organisational expertise in many areas that could make a critical contribution to China's economic growth, whether in emerging industrial technologies, environmental or health services, or the operation of financial markets. China has surplus capital that it wishes to invest profitably

around the globe, at the very time when Europe is looking to renovate its ageing infrastructure and to raise more capital for the expansion of innovative companies. It also has an increasingly skilled and well-educated workforce. A combination of European ideas or expertise and Chinese capital and skilled labour could be a winning combination, if such collaboration could be made to work. The EU also has the distinct advantage of not being perceived by China as a rival regional power, and indeed, not as a power at all in the traditional sense.[1]

The thesis of this book, however, is that this promising potential for cooperation is repeatedly undermined by major political differences, not only *between* China and the EU but also *within* China and *within* the EU, some of which are unlikely to disappear in the foreseeable future. At least three types of political differences that constitute major obstructions to EU–China economic cooperation will be illustrated in the course of this narrative.

The most obvious example is provided by the different political assumptions that underlie economic policy in the EU and in China. Differences of view regarding the role of competition in the market, or the place of the state and the private sector in the economy, complicate discussion of economic relations between the People's Republic of China and any developed economy. The dominant position of state-owned enterprises (SOEs) in China, for example, affects the structure of the market, its efficiency and prospects for future growth, as well as the space available for non-Chinese competitors. China's determination to develop indigenous industrial sectors and technologies capable of competing internationally leads it to overlook or bypass the normal rules of the game. More fundamentally, the Chinese Communist Party (CCP)'s restrictive approach to property rights, open access to information, and the rule of law, all fundamental tenets of economic governance in the West, generate uncertainties and lack of trust that inhibit cooperation over the long term. The analysis in the following chapters will show how economic reform in China aims to address some of these problems, but fundamental differences of opinion persist in China over the choice of a market-driven or a state-driven economic model. Nationalism remains a powerful force, given new vigour by President Xi's "Chinese Dream."[2] Economic reform has so far been tentative and gradual. It has not yet reached a point where economic cooperation with China can be approached in anything like the same way as with other partners.

Differences in the political leverage exercised by a sovereign state like China and an association of sovereign states like the EU accentuate the difficulties arising from different political assumptions. The EU treaties confer a political role on the Union, including responsibility for the management of key aspects of the external economic relations of its Member States, such as trade and investment, but, as later chapters will show, the Union has considerable difficulty in exercising its mandate. The complicated division of competences between the Union and the Member States, combined with disagreements between Member States on some economic fundamentals, often means that it cannot formulate and deliver a coherent external economic policy, particularly towards a partner as large, strong, and fast-changing as China. Some of its biggest Member States do not always accept that their interests are best served by collective external action. Meanwhile, China has shown its willingness to deal with individual EU Member States or groups of them where it can, whilst repeating its commitment to closer relations with the EU as a whole. This tension between centralised and decentralised decision-making affects China as well as the EU: one of the more difficult political issues in China's economic reform is that of greater fiscal autonomy for China's provincial governments. The capacity of both China and the EU to manage the balance between centralised and decentralised power, albeit from very different starting points, will be an important factor in shaping future EU–China economic relations.

A third example of political difference affecting EU–China economic relations is the debate within the EU over the nature of the EU's common external policy: should it be values-based or interest-based?[3] Advocates of a values-based approach maintain that the EU's foreign policy cannot separate economic goals related to trade, investment, or other forms of international cooperation from the promotion of European values, such as the protection of human rights, democratic freedom of expression, and the rule of law. Such a values-based approach would stand in the way of closer EU–China economic relations as long as China does not undertake fundamental political reform, which the present Chinese leadership is not contemplating. Many in the EU, however, advocate a more interest-based policy, in which economic interests are to be pursued with international partners separately from and (by implication) without conditionality in terms of acceptance of European values by the EU's international partners. China presents this choice of approach for the EU in its most acute form, and it will be central to, for example, future discussion by the European Parliament of proposals to conclude agreements between the EU and China on investment or on free trade.

## Why Another Book on China?

Academic literature on EU–China economic relations is fairly abundant, if much less so than analysis of USA-China relations. Many of the works take the form of journal articles or edited volumes that focus on specific features of the relationship, such as trade or investment or environmental policies, whilst some have included a combination of issues aimed at a particular audience. A recent example of this type is a wide-ranging guide to EU–China relations for European businessmen and potential investors produced by participants in the European Commission's Europe-China Research and Advisory Network (ECRAN).[4] The authors recognise their debt to the work already done by many others in this field of scholarship.

However, this book is different and offers three distinctive characteristics. First, the chapters presented here deliver an analysis of each of the main components of the EU–China economic relationship within a single framework, which takes into account a new background of changing economic fortunes in the EU and China. Such an integrated examination can help to identify recurring common features in the relationship across different sectors and allow cross-cutting conclusions to be drawn about its nature and direction.

A second distinguishing feature of this analysis is that it takes account of the economic and political environment emerging from the post-2008 economic and financial crisis. Attitudes to China across the EU have changed as a result of the economic crisis. China's continuing economic growth, in spite of the post-2008 recession in other parts of the world, has helped China become the second most important market for European exports after the USA, and its growing activity as an overseas direct investor has led to its being solicited by heavily indebted EU Member States as a long-term investment partner. Meanwhile, because of the effects of the recession on China's export markets, the Chinese leadership has recognised that economic reform, aimed inter alia at changing the China's economic model from an export-dependent to a domestic consumption-dependent one, is becoming urgent. Economic reform could transform the prospects for EU–China economic relations, but the evidence since the CCP's Third Plenum meeting in 2013 suggests that progress towards reform will be gradual and uneven. The incorporation into this volume of analysis of issues such as environmental sustainability and monetary policy, for example, will also help to illustrate the political dilemmas that economic reform in China brings with it.

The third main justification of this book is the specific situation of the EU. Its institutional arrangements imply a unity in its external economic policy that is often contradicted by the behaviour of its Member States. This issue deserves detailed analysis, especially in relation to an emerging power as important as China. The need to work out a new form of relationship with such a challenging economic partner is proving to be yet another stress test of the Union's capacity to act as one. The evidence so far suggests that the EU may not pass this test in all areas of EU competence.

The book that follows is conceived as an analysis useful for university faculty and students interested in China and the EU, as well as for the general reader, who may have a professional interest in economic relations between Europe and China as a businessman, civil servant, campaigner or politician, or who may simply be aware that China counts for something in today's world and is curious to know what that means for the future of Europe. The goal of this work is to provide an empirically-led examination that is academically informed but approachable for a wide readership.

Sources used for this book have been varied. The book's distinguishing feature is the incorporation of primary source interviews with a number of EU and Chinese officials involved in negotiations or consultations, as well as a number of political figures on the EU side. Published sources include meeting minutes and seminar records from EU and Chinese organisations (e.g., EU–China dialogue groups or the Chinese Academy of Social Sciences [CASS] Institute of European Studies [IES]), official papers, research think-tank reports, conferences, and seminars participated in by the authors, as well as current scholarship from journal articles and books. Statistics have been sourced from international organisations (International Monetary Fund [IMF], World Bank, United Nations Conference on Trade and Development [UNCTAD], and Organisation for Economic Cooperation and Development [OECD]), Eurostat, and official Chinese sources. The breadth and depth of these references are intended not only to support the arguments offered in each chapter but also to provide the interested reader with further avenues of exploration on each of the topics covered by this book.

## Outline of Chapter Structure

The book is divided into three parts.

Part I, *EU–China Relations in a Global Context*, sets the scene for the analysis of particular areas of economic activity in Part II. Beyond the present chapter, which explores the political issues that underlie the

economic relationship, two further chapters examine the overall context of EU–China bilateral economic relations and the international institutional framework in which the two sides operate and cooperate.

Chapter 2, *The EU's Growing Links with China's Reforming Economy*, introduces China's extraordinary economic re-emergence over the past four decades, the development of EU–China political and economic relations, and how that has contributed to both economies. Themes developed include the importance of EU–China trade and investment for both sides, China's contribution to improving EU industrial competitiveness, employment and living standards, and the importance of China as an export market. An assessment will also be made of the EU's economic importance for China as an export market and a source of inward investment, technology, and ideas.

The analysis also shows how, despite its dynamism, the EU–China economic relationship remains under-developed, taking as examples the large and persistent imbalance in two-way trade and its causes, the weakness of investment links, the limited role of China in the international monetary system, and lack of cooperation in industrial innovation and research. A comparison with the relations that the EU enjoys with other developed or emerging economies will illustrate these shortcomings and point to differences between the EU and China in terms of openness.

Chapter 3, *The EU and China in the Governance of Global Financial and Trading Systems*, analyses the latest developments in the institutional framework for international economic relations and the roles played by China and the EU within it. The chapter examines the concept of global governance and shows how China and the EU engage with each other in the domain of international economic, financial, and trade regulation, explaining why the global economic system is so important to this bilateral relationship and analysing why such interactions are becoming increasingly problematic at both bilateral and multilateral levels.

China's role as a re-emerging power is examined alongside that of the EU to show how different interests and priorities now exist between the two that are having a tangible impact on the evolution of global governance. The chapter argues that the longstanding US-led consensus on how the system should operate, who should be its leading decision-makers, and what should constitute norms of behaviour are coming under closer scrutiny and increasing strain. The argument concludes that, whilst some progress towards agreement is being made in the operation of particular sectors, such as in financial regulatory systems, in a number of other parts of the current systemic framework deep discord between the EU and China persists.

Part II, *Opportunities and Risks in the EU–China Relationship*, examines five areas of the EU–China economic relationship in turn: trade, investment, innovation and research cooperation, monetary affairs, and cooperation on common economic challenges (in particular, concerning the environment, climate change, energy policy, and urbanisation). Each chapter analyses the policy goals of China and the EU, examines current points of tension or shortcomings in the relationship, and assesses the likelihood of policy changes to address these problems.

Chapter 4, *Trade*, examines the changing character of EU–China trade and focuses on specific areas of trade conflict, in order to identify their underlying causes and assess whether the importance of EU–China trade is on an upward or downward trajectory. For the EU, the main problem is what might be termed as asymmetric reciprocity in the bilateral trading relationship with China—in other words, a one-sidedness whereby, whilst Europeans present what is strongly defended as an open single market, the Chinese maintain barriers to market access in some sectors, compete unfairly both in the EU and international markets because of subsidies or dumping, and restrict exports of raw materials. China, by contrast, focuses on EU reluctance to recognise China as a market economy under World Trade Organisation (WTO) trade defence rules, its maintenance of an embargo on arms exports to China, and the potential damage to Chinese interests arising from a mooted Transatlantic Trade and Investment Partnership (TTIP) between the EU and the USA.

The analysis assesses the real as opposed to perceived impacts of existing barriers, the kinds of policy change being sought by the aggrieved party and the political difficulties that any change would present to the other party. The chapter concludes that EU–China trade seems likely to continue to develop, albeit at a slower pace than hitherto, but suggests that the changing competitive position of China (facing rising labour costs, difficulties in innovating and increasing competition within Asia) alongside growing vigilance of the EU regarding subsidies and appropriation of intellectual property in new technologies, may lead to more rather than less conflict in future.

Chapter 5, *Investment*, explores how two-way EU–China direct investment flows are growing but remain far below what would normally be expected between such large economies. EU investment in China is constrained by legal exclusions in many economic sectors, restrictive conditions where investment is permitted, and fears of forced technology transfer and unreliable intellectual property protection. Chinese investment

in the EU, on the other hand, is growing quickly from a low base and is generally welcome, although there is concern amongst Member States about the political risks of investment in strategic sectors, albeit with some disagreement about what constitutes a strategic sector.

The chapter assesses the prospects for the negotiations under way between the EU and China for a bilateral investment treaty (BIT). Such an agreement will only be reached if vested interests and political sensitivities about national security on both sides can be overcome. The EU will, for example, have to agree on a common approach towards Chinese direct investment in Europe—an area in which competition between Member States is fierce and policy differences between them are pronounced. China will need to review its policy of protection of SOEs in key economic sectors, including health, public utilities, and financial services. The analysis examines the policy areas in which resistance to change on each side may inhibit possibilities to reach a substantive agreement, concluding that significant differences and formidable difficulties remain.

Chapter 6, *Innovation and Research*, examines areas of contrasting yet complementary abilities between China and the EU, presenting evidence to show that China enjoys competitive success in incremental innovation but is relatively weak in key aspects such as basic research and the commercialisation of disruptive innovation, when compared to advanced industrialised economies such as the EU. China and the EU are each investing heavily in research and innovation as key inputs needed to make both of them more productive, and, superficially, this might indicate each side having shared interests and compatible talents. Yet persistent political obstacles to closer partnership are shown to be inhibiting the trust-building necessary for future success.

Whilst recognising genuine achievements at the level of some individual projects, the ambition for further progress is assessed against the apparent failure to realise more extensive structural cooperation because of inhibitors on both sides. On the Chinese side, these are shown to include weakness in intellectual property protection enforcement, preferential government procurement that favours domestic Chinese firms, and compulsory technology transfer rules. On the European side, inhibitors include policy fragmentation that undermines pan-European coherence, coupled to Member State zero-sum mentalities regarding engagement with China at the same time as the European Commission is seeking to agree priority pathways with China. The chapter concludes that unless such obstacles can be overcome it will difficult to realise the potential for cooperation.

Chapter 7, *Monetary Affairs*, examines the current international position of the euro and the renminbi (RMB) and assesses how policy changes under way in this area may affect the broader economic relationship between the EU and China. Whilst the Eurozone countries and China both have an interest in promoting greater international monetary stability and consult regularly on monetary affairs, each faces political challenges at home in seeking to strengthen the international acceptability of their currency.

The RMB is rapidly becoming one of the world's most traded currencies and from October 2016 will become a component of the Special Drawing Right (SDR), an international monetary unit managed by the IMF, but as long as it is not fully convertible, then China's position in international monetary affairs will remain significantly less influential than its economic weight would warrant. China has announced a long-term plan to achieve convertibility and has begun to liberalise parts of its financial markets. The political risks of such reform, however, are very great: allowing a competitive market to develop in China, and liberalising domestic interest rates, would effectively remove Party control of the banking system and the capacity to direct bank lending and increase volatility of the exchange rate. The euro, too, has a credibility problem. The political choices behind the Eurozone's banking union and common economic policy affect growth and jobs: Differences between Eurozone members on how to achieve those goals are deeply entrenched and unlikely to be resolved soon, and they are already affecting the euro's standing as an international currency. The chapter concludes with an assessment of the repercussions that greater integration of the China's currency into the international monetary system will have for the EU as a whole.

Chapter 8, *Cooperation on Common Economic Challenges*, examines cooperation between China and the EU in policy areas addressing common economic challenges, such as environmental sustainability and energy efficiency. The work programmes of four policy dialogues between EU and Chinese officials (environmental policy, climate change, energy policy, and urbanisation) are assessed in terms of their capacity to deliver knowledge transfer and business-level economic cooperation between EU and Chinese partners or to influence the policy of either side. Some of the political obstacles to cooperation referred to earlier are found here: reluctance on the Chinese side to extend cooperation to joint business ventures in China, a lack of reciprocity in information flows, and, in some areas, competition between EU-level and Member State cooperation with China.

Part III, *The Importance of EU–China Economic Relations in the Coming Decade*, takes stock of the political constraints to closer and more stable economic relations between the EU and China that have been discussed in Part II, first in terms of the global context, largely shaped by each side's relations with the USA (in Chap. 9), and in relation to domestic political developments within China and the EU (Chap. 10).

Chapter 9, *Elephant in the Room: The Role of the USA in EU–China Relations*, examines how relations between the EU and China are influenced by the very different interactions between each of them with the USA, for one, a longstanding strategic ally and preferred economic partner, for the other, a regional competitor and the prime mover of a policy of encirclement or containment of China. This chapter analyses the inescapable influence of the USA on EU attitudes to China but also explores how the growing economic links between Europe and the Chinese are beginning to change some European countries' response to the USA.

The longstanding connection that the USA enjoys with the EU as an institution and with individual Member States of the Union in particular is examined and is shown to reflect America's role as global hegemon and principal architect of the post-World War Two global order. The chapter shows how the triangular factors of the US–China–EU relationship interconnect in important ways, how differing Member State attitudes towards the USA may be driven by closer national-level relations with China and how the US influence reaches into the policy formation of the EU in its relationship with China. Evidence is presented to support a conclusion that the EU has become operationally dysfunctional in handling this triangular complexity and in defining a coherent strategy to deal with the variable geometry of power that now characterises contemporary East and South East Asia.

Chapter 10, *Optimism or Pessimism about the future of EU–China Economic Relations?*, summarises the analysis of the preceding chapters. It first reviews the fundamental political obstacles to closer EU–China cooperation that have already been identified and classifies them in terms of their significance as a roadblock along with their likely durability. Second, it divides the main areas of EU–China economic interaction into two categories: those where it is possible to be relatively optimistic about the development of closer EU–China economic cooperation, because of a conjunction of joint interest and a low incidence of political obstacles, and those (more numerous) where pessimism seems to be called for, either because EU and Chinese interests are in conflict or because domestic political obstacles to cooperation are unlikely to be removed within a relevant time-scale.

## Conclusion

There are two working hypotheses that underpin this book's analysis. First, that the EU and China have sound economic motives for trying to work together in the common interest and to enhance their cooperation, given the many links that have developed between their economies in a remarkably short space of time. The rhetoric of the European and Chinese political leadership continues to underline the importance of their Strategic Partnership: goals are set for it that are often surprisingly ambitious—such as that of the 2014 EU–China Summit, that aimed to nearly double the annual value of EU–China two-way trade and investment exchanges by the year 2020, to the round figure of €1 trillion per annum.[5] However, close examination of how the economic relationship is actually working in practice provided by each chapter supports the book's second hypothesis, which is that in nearly every sphere intractable political difficulties stand in the way of a fundamental alignment of economic interest between the EU and China, and that the main activity of their economic diplomacy is to find ingenious ways of living with or circumventing these political differences.

Such is the economic influence of China that, for the European side at least, these political difficulties are usually not allowed to stand in the way of at least maintaining mutually advantageous exchange. But any shift to a higher level of cooperation may, indeed, run into difficulties deriving from ideological differences. These may be due to the differing views of the EU, on the one hand, and China on the other, about how the international economic system works and the role of states within it. They may, however, also be due to differences of view that are internal to China or to the EU: between economic reformers and conservatives within the CCP, or between federalists and anti-federalists within the EU. Whatever form they take, the thesis of this book is that these differences are strongly held, relatively immune from foreign influence, and unlikely to evolve into a new settlement for EU–China economic cooperation in the foreseeable future. The next few years, therefore, might be better spent improving the *status quo* at the edges. More optimistic forecasts of the future of the EU–China relationship may have to wait for major political change on one side or the other.

## Notes

1. China is often characterised as operating in ways that accord with a broadly "realist" world-view of international relations, premised on competing power dynamics between sovereign states, building alliances, and mitigating threat perceptions in a modern international system whose anarchy is only partially offset by the evolution of issue-based institutions and regulatory regimes. The EU, by contrast, is typically characterised as a distinctive post-Westphalian organisation whose members have voluntarily agreed to pool sovereignty and accept a semblance of supranational authority over key areas of domestic and international policy-making. For some interesting background reading on these concepts and how they may impact contemporary EU–China relations, see Ian Manners, 'Normative Power Europe: A Contradiction in Terms?', *Journal of Common Market Studies* 40, no. 2 (2002), 235–258; Fraser Cameron, 'The Geopolitics of Asia—What Role for the European Union?', *International Politics* 47 (2010), 276–292; Liqun Zhu, 'Chinese Perceptions of the EU and the Sino-European Relationship', in *China-Europe Relations: Perceptions, Policies and Prospects*, edited by David Shambaugh, Eberhard Sandschneider and Hong Zhou (Abingdon: Routledge, 2008); Tang Shiping, 'From Offensive to Defensive Realism a Social Evolutionary Interpretation of China's Security Strategy', in *China's Ascent: Power, Security, and the Future of International Politics*, edited by Robert S. Ross and Feng Zhu (Ithaca, NY: Cornell University Press, 2006).
2. For more on the background to this idea, see a Special Report from China's State News Agency: Xinhua, 'Chinese Dream' <http://www.xinhuanet.com/english/special/chinesedream>, accessed 20 December 2015.
3. For further discussion of these concepts, see: Paul Irwin Crookes, 'Resetting EU–China Relations from a Values-based to an Interests-based Engagement', *International Politics* 50, no. 5 (2013), 639–663.
4. Kerry Brown, *China and the EU in Context: A Guide for Businessmen and Investors* (Basingstoke: Palgrave Macmillan, 2015).
5. European Commission, 'Joint Statement: Deepening the EU–China Comprehensive Strategic Partnership for Mutual Benefit', *European Commission Press Release Database* <http://europa.eu/rapid/press-release_SPEECH-14-2160_en.htm>, accessed 22 October 2015.

CHAPTER 2

# The EU's Growing Links with China's Reforming Economy

*Key questions:*

- *How important is China to the world economy?*
- *Why have EU–China economic links developed so quickly?*
- *What are the positive and negative points in the EU–China economic relationship?*
- *How is the emergence of the knowledge-based economy affecting the EU and China?*

China and the EU, two economies that represent one-third of the world's gross domestic product(GDP),[1] have in recent decades become partners to the point where, whether they like it or not, their economic futures are interlinked. Taking the next steps towards a partnership that will generate greater mutual benefit, however, presents political challenges for each that go well beyond what has already been achieved.

This chapter will review the current state of the EU–China economic relationship, starting with China's extraordinary economic re-emergence from political radicalism and economic autarky since the death of Chairman Mao in 1976. It will then summarise the main features of economic relations between the EU and China, based on trade, investment, and technological exchange, and assess their impact on economic growth and prosperity of each. It will point out gaps and shortcomings in the relationship, compared to those that the EU enjoys with other partners. It will, finally, suggest that the development of knowledge-based economies, in which innovation, access to information, and protection of intellectual

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property play a major role, present new policy challenges for governments and that the very different approaches taken by China and the EU to them could be a complicating factor for their future cooperation.

## China's Economic Rise and Growing Global Weight

The economic re-emergence of China has been well documented, most strikingly (in English) by such authors as Jonathan Fenby, Niall Ferguson, and Martin Jacques.[2] All have made the point that this process can be seen as the correction of an historical anomaly, insofar as China is today reclaiming the position of importance in the global economy that it enjoyed until the early nineteenth century. But if China's economic re-emergence may have been expected after its rejection of Maoism, its speed and scale were quite unforeseen at the outset and have proved to be unprecedented. Never has a country risen so quickly from global economic insignificance to become a global economic power. Since reforms began to be implemented from the late 1970s, China has evolved from a bystander in the world economy to one of its prime movers. As an example, indications during the summer of 2015 of a decline in China's economic growth rate and the temporary shutdown of its stock markets led to sharp declines in other stock markets around the world and a further depression of commodities and shipping markets. Until now, only the USA has had such influence.

This transformation is already impressive when described in macroeconomic terms, looking at changes brought about in the Chinese economy as a whole. It is even more striking in terms of the changes it has brought to the Chinese people.

Since 1978, the Chinese economy has moved from a mainly agrarian to a manufacturing and service economy; from a country with most of its population based in the countryside to one in which the majority lives in urban areas (without taking into account the migrant labour force in urban areas that is not reflected in official statistics); from an economy largely bypassed by world trade to the world's single biggest exporter and importer; from a low-growth developing economy to one that generates half the world's economic growth; from one of the world's poorest economies to that of a middle-income country; from an economy with no external financial assets to the world's largest holder of foreign exchange reserves and second largest foreign direct investor (Table 2.1).[3]

**Table 2.1** China's economic transition, 1978–2014

| *Sector of China's economy* | *GDP composition* | | *Occupation percentage* | |
|---|---|---|---|---|
| | *1978 (%)* | *2014 (%)* | *1978 (%)* | *2014 (%)* |
| *Primary* (agriculture, forestry, fisheries) | 28 | 9.2 | 71 | 31.4 |
| *Secondary* (manufacturing, utilities, construction) | 48 | 42.7 | 17 | 30.1 |
| *Tertiary* (ICT, business services, retail, other services) | 24 | 48.1 | 12 | 38.5 |

*Sources*: Based on data from The World Bank Country Indicators, http://data.worldbank.org/country/china; CIA World Factbook on China, https://www.cia.gov/library/publications/the-world-factbook/geos/ch.html; China Statistical Yearbook 2014, http://www.stats.gov.cn/tjsj/ndsj/2014/indexeh.htm, all accessed 10 October 2015

China's share of global activity has grown steadily—some would say relentlessly. Measured in terms of purchasing power parity (which takes account of the real cost of goods and services in different parts of the world), China's GDP has risen from just over 2 % of global GDP in 1980 to a share that exceeds that of the USA and is only slightly less than that of the EU (18 % of world GDP in 2014, compared to 18.3 for the EU and 17.6 for the USA). Although China's GDP expressed in US dollars is only two-thirds that of the USA, the World Bank has predicted that China will become the biggest economy in the world by 2030.[4]

This economic revolution has had an extraordinary impact on the Chinese people. Average incomes have increased tenfold in real terms over the past 30 years. Although 100 million Chinese people are still defined as "poor" by the World Bank, about 500 million have emerged from poverty in the same period.[5] Consumer goods that were unavailable in China 40 years ago have become widespread, especially in urban areas, where cars have replaced bicycles. State-funded health and social security systems have been introduced for most of the urban population and are being extended to the countryside. Mobility of workers within China has become much more common and the growth of the Chinese middle class means that over 100 million Chinese citizens now leave the country each year as tourists or students.[6]

China still has to address formidable economic and social challenges, but these no longer concern survival. The government's priorities now relate to improving the distribution of wealth, on the one hand, by narrowing gross inequality of income, eliminating corruption and

improving health care and education for the whole population, and ensuring economic sustainability on the other hand, by replacing export-led growth by domestic demand-led growth, managing the transition to a more knowledge-based economy, and combatting the environmental and health threats of decades of pollution.

How China chooses to address these issues will have a significant impact on the rest of the world, because its rapid economic re-emergence has fundamentally altered the distribution and nature of global economic activity. The main driver of change has been international trade, particularly following China's admission to the WTO in 2001, which provided the stability of a rules-based system for China's international trade at the same time as its pool of low-cost labour provided the source of a massive increase in its industrial output. China is the second most important generator of international trade on the planet after the EU.[7] It is the leading single-country destination for exports from the rest of the world: a dominant consumer of energy and raw materials, a huge and fast-growing market for goods and services, and an increasing consumer of imported food. Changes in China's predicted economic growth rate have an immediate impact on international commodities markets, as they did in 2015, when commodity prices fell by 23 % largely because of growing doubts about recovery in Chinese demand.[8] China alone accounts for a major share of global demand for iron ore, copper and other metals, as well as wool and oil.

China is the second most important exporter in the world (after the combined total of the EU Member States), as a competitive supplier of finished manufactured goods, ranging from textiles and clothing to machine parts, computers, telecommunications equipment, transport goods, and wind turbines. It is a growing supplier of engineering and construction services. Its biggest customers include the world's most developed and sophisticated markets; the EU and the USA account for two-fifths of its exports. Its success as an exporter, combined with protection of key parts of its own market from trade, results in trade surpluses with the developed economies in particular, providing net inflows to bolster foreign exchange reserves that can offer valuable support in volatile economic times.[9] Despite reserves falling sharply in the second half of 2015, this steady income stream has allowed China to accumulate one-third of the world's total foreign exchange reserves, worth about 35 % of China's GDP.[10]

A key driver of this process has been the development of global supply chains in manufacturing, whereby industries in developed economies, in

order to reduce their production costs and remain internationally competitive, have outsourced all or a substantial part of their manufacturing process to regions where production costs are significantly lower. The obvious cost difference has been that of labour; the last 20 years has seen a rapid increase in the international division of labour on an unprecedented scale. Other costs, however, such as land, energy inputs, and regulatory compliance, can also be relevant. Technological change has meant that the cost of transporting goods from production plants to markets in other continents has fallen steadily. China has been well placed to take advantage of this phenomenon. It has been able to provide a low-cost production base on an unrivalled scale, because of a pool of cheap labour in rural China ready to migrate to the cities and provide the workforce for rapidly developing manufacturing industries. Over 200 million people moved to the cities in the first decade of this century and 300 million more are expected to do so by 2030, even if labour costs in China are steadily rising.[11]

This comparative advantage was reinforced by the decision of the CCP leadership in the early 1990s to develop the Chinese economy at high speed as a matter of political survival. Following the political unrest of 1989, the legitimacy of the Party was to be sustained by improving the country's economic performance. This convergence of interest between manufacturing firms based in economies that were less cost-competitive than China but had the technology and know-how that China needed, on the one hand, and the CCP, on the other, has led to the situation where about half of China's manufactured exports are produced by firms that are wholly or partly foreign-owned.[12] The share of foreign-owned firms in China's most advanced manufactured exports is even higher.

China has also become a major overseas investor. Its outward foreign direct investment (FDI) flows increased about a 100-fold between 2000 and 2014.[13] The process began with investments in countries producing raw materials or foodstuffs, particularly in Africa and South America, but it has diversified into manufacturing and distribution activities in the developed countries, including for advanced technology products. China's total overseas stock of FDI remains small compared to that of some developed economies, such as the USA or the UK, which have been investing in foreign countries for a century or more, but its annual outward FDI now surpasses all but that of the USA.[14]

China also holds important investments in foreign government and private sector securities. The most striking example of its weight is its

holding of US$ 1.24 trillion in US Treasury bills, or about one-fifth of US debt, despite falling from peak levels in 2013.[15] China is seeking to diversify its foreign debt holdings beyond the US dollar, however, and also holds European, Asian, and South American public debt. China's investment behaviour is increasingly influential as an indication of the level of international confidence in a currency, including the euro.[16] Beyond such bilateral initiatives, China has also been active in the creation of new international financial institutions, such as the Shanghai-based New Development Bank for the BRICS countries (Brasil, Russia, India, China and South Africa) and the Asian Infrastructure Investment Bank (AIIB).

Later analysis will show that China is not a serious competitor in all fields and that its position is being eroded even in the areas where it is currently strong. Nevertheless, its size, continued economic growth and overall leverage on the world economy mean that what China wants, and where China wants to go, are questions that economic policymakers around the world have to take into account.

## The Growth of EU–China Interdependence and Its Impacts

Over the past four decades, the European and Chinese economies have become much more closely interlinked, to a point where a breakdown or even a weakening of the economic relationship would cause damage to both sides. That is partly a result of the sheer volume of economic activity generated by EU–China trade, which has brought two of the biggest markets in the world closer together. Even more important is the nature of the links between them, whereby the industrial tissue of each economy has become partly reliant on the other. European companies have benefitted from a closer relationship with China not just as a market for their products (where, until the recent expansion of the Chinese middle class, their opportunities had been limited) but also as a source of competitiveness through the supply from China of material and components for their own production. Similarly, China has not only gained a large market for its exports in the EU but its own industrial capacity, competence, and competitiveness have been increased through European-financed investment and technology transfer.

This interaction between the EU and Chinese economies can be illustrated in three areas: trade, investment, and technology and knowledge transfer.

### *Trade*

The EU engaged with China at a relatively early stage in its post-Mao re-emergence. As the European Economic Community, it concluded a Trade and Cooperation Agreement with China in 1985, relatively soon after the first signs of opening up of the Chinese economy in 1978.[17] This Agreement is still the only formal agreement between the two sides. Negotiations for a more ambitious Partnership and Cooperation Agreement, launched in 2008 and intended to reflect the spirit of the 2003 Strategic Partnership, have foundered: they have been described to the authors by a senior EU trade official as "not merely moribund but mummified."[18]

Since 1985, China–EU trade has developed at an extraordinary pace. The value of two-way annual trade has increased 200-fold in nominal terms. Even after discounting inflation, this amounts to an average year-on-year increase of 11 %. Two-way trade has quadrupled since the year 2000 and has continued to grow, despite the post-2008 financial crisis and an economic downturn in Europe. The EU and China have become pillars of each other's international trade. China trades more with the EU than any other trade partner (the EU provides 12 % of China's imports and takes 14 % of its exports). It is the EU's second export market (10 % of the total), well behind the USA (at 16 %) but with a growing share.[19] It was one of the fastest-growing EU export markets of the past decade, with exports more than tripling in the decade 2003–2012. Both economies are relatively trade-dependent. The value of EU–China two-way trade, worth €520 billion in 2014, represents 3 % of the EU's GDP and 5 % of China's.[20]

The EU's open trade policy has contributed to the growth of trade links. The EU has tended to favour the European consumer interest in obtaining competitively priced imported goods rather than the European producer interest in protection against competition. Measures to defend EU producers against imports from China benefitting from unfair trade practices under WTO rules affect only a tiny proportion of total trade.[21] The Chinese market itself became more open following China's accession to WTO in 2001 in sectors of importance to China and opportunity for the EU, such as machinery and cars. In return for non-discriminatory access to the world market, China agreed to reduce its tariffs to relatively modest levels—significantly lower than those negotiated earlier by other emerging economies such as India or Brazil—and to commit itself to multilateral rules for the management of its trade, including non-discrimination

and "most favoured nation" treatment.[22] And in the past decade, the Chinese market has become much more attractive to European exporters as the wealth of a fast-growing middle class increased and as China's industrial capacity broadened, providing a market not only for high-value consumer brands but also for advanced production technology, in particular from Germany.

Whilst China and the EU have continued to trade more with each other each year, however, there are problems. Their trade is unbalanced, subject to restrictions on both sides, and occasionally perceived by one or the other party to be unfair.

China continues to export to the EU about twice as much as it imports. (The same applies to an even greater degree to China's trade with the USA). China's trade surplus with the EU began to cause concern in the mid-1990s; it reached a peak of €162 billion in 2008, before falling to €145 billion in 2014. A slower rate of economic growth in China in 2015 suggests that the deficit may start growing again.[23] A plausible explanation of this trade imbalance could be comparative advantage, i.e., that China is a more competitive producer than the EU and that high-cost EU goods and services cannot find buyers in the Chinese market. That is partly the case. A comparison between like-for-like products suggests that China still enjoys a considerable cost advantage over the EU, even compared to the least-developed EU regions. Labour and land costs in China have been much lower than those of the EU for some time, even if they are now rising quickly; labour costs rose more than 20 % a year in 2011 and have remained at double-digit growth since then. Labour has also been unorganised. The cost of compliance with social and environmental regulation is much lower for producers in China than in Europe. Such cost advantages have encouraged European producers to invest in China.

But China's competitiveness is not universal. There are many goods that it is unable to produce (such as advanced manufacturing tools, or specialised chemical and medical products). There are other goods and services that China can supply but not as competitively as external suppliers, including the EU (such as advanced passenger aircraft or high-performance motor vehicles, or services such as banking, insurance, brokerage, logistics, retailing, and specialised health provision). In areas such as these, access to the Chinese market has been restricted to protect domestic producers. WTO trade rules leave a considerable margin for the protection of domestic economic interests by other means than tariffs.[24]

The other major problem for EU–China trade is the risk that differences in industrial policy and banking systems between China and the EU, and

their different approaches to competition and the use of subsidies, may result in unfair trade. There has been a growing level of concern within the EU about the impact of the Chinese approach to industrial development on trade, not only within the EU market, as Chinese state-owned companies have become important competitors in sectors such as telecommunications, energy supply, and transport, but also in other international markets, where Chinese government support for exporters, in the form of export credit insurance, for example, has grown rapidly over the past decade.[25]

### *Investment*

Investment flows between the EU and China have lagged far behind trade but since the turn of the century are becoming more important. International interest in investing in the Chinese economy has increased and China has itself become an exporter of capital.

China has been a major recipient of FDI since the 1990s, and much of its subsequent economic transformation has been derived from that. The accumulated stock of inward FDI is valued at about 20 % of Chinese GDP.[26] The initial investment flow from the EU was modest, averaging about €1 billion a year in the 1990s, but it increased tenfold over the first decade of this century. Despite fluctuations in the wake of the euro and sovereign debt crisis, EU investment flows into China continue to be significant, although recording a fall in 2014 from the highs of previous years to €9.1 billion.[27] China has consistently been one of the top five important destinations of EU FDI, tending to concentrated in the manufacturing sector, although the services sector has become more important in recent years. Today, EU Member States provide a fifth of total FDI in China, ahead of the USA but well behind some of China's immediate neighbours such as Japan, South Korea, and Taiwan.[28]

China has moved, however, from a relatively open position towards foreign investment in the 1990s, when it was not internationally competitive, to a more restrictive one today. Complaints have become louder from EU and other foreign businesses about new Chinese restrictions on inward FDI. Services such as financial services or health provision have been subject to severe restriction. Even where foreign investment is permitted, restrictions on the level of foreign ownership or the number and scale of operations may reduce its attractiveness. Other constraints on foreign investment in China include uncertainty about property rights, whether physical property (land and authorisations for its use) or intellectual and industrial property, and the absence of national treatment for foreign

investors, including alleged discrimination in the application of labour, environmental, or tax legislation. EU companies have alleged that as China becomes more competitive, it is seeking to reserve future growth in the Chinese market for domestic companies and reduce the share of foreign-owned ones. They are consequently setting more modest expectations for their China operations and revising down investment plans, and half are already routinely reviewing investment opportunities elsewhere in Asia.[29] The Chinese government announced modest liberalisation of rules on investment in 2015 but its implementation is judged to be too slow. The political debate within China about the future role of foreign investment is clearly still open.[30]

Meanwhile, China has started to export capital on a large scale, even if its total stock of outward FDI is still relatively modest, at about 1 % of GDP (compared to about 10 % for the EU). Chinese foreign investment is now diversifying towards developed economies, including the EU, as part of an effort to secure markets and, more recently, to purchase technology and skills, growing in the EU at a significant rate per year since 2009 and reaching €12.1 billion in 2014 (meaning that China became a net investor with the EU that year).[31] The interest of several EU Member States in encouraging Chinese investment in large-scale infrastructure, such as ports, motorways, airports, telecommunications systems or power generation, has accelerated the rate of growth of inward investment flows, but has also generated a political debate about the security, reliability, and commercial fairness of such investment. Despite such political attention, however, EU–China investment links remain relatively weak; the annual flow of direct investment between the EU and China amounts to less than 3 % of their combined outward FDI. And only 2 % of the EU Member States' FDI stock is in China, compared to 30 % in the USA.[32]

China and the EU have expressed a strong interest in investing more in the other region, and are negotiating a BIT, but this goal will not be achieved without China accepting greater competition in its home market and Europe being prepared to take greater political risks.

### *Technology and Knowledge Transfer*

The transfer of industrial technology and know-how by foreign investors is an important means of accelerating industrial development. European companies have been heavily involved in such transfers to China. This happened first in the industrial sectors where EU industries used China as a

low-cost source of supply for finished consumer goods (such as clothing, electrical and electronic goods) or as a production platform for components of producer goods to be completed in Europe (machinery and transport goods). A second phase occurred in the first decade of this century, as fast-growing demand in the Chinese domestic market encouraged European investment in manufacturing plants in China for cars, pharmaceuticals, or chemicals.

Technology and know-how transfer has so far been one-way, from Europe to China. It has taken place, however, against a background of concern about Chinese governmental pressure on foreign investors to transfer technologies to China and the uncertainty of intellectual and industrial property protection in China. EU companies that are present in many other regions of the world tend to carry out less innovation and research in China than in other regions, not only because there are few areas in which China's level of knowledge and research capacity is equivalent to that in Europe but also because, even where research in China might be an attractive option, companies are reluctant to run the risk that knowledge shared with a competitor may be lost. Protection under the Chinese legal system against the theft of ideas is judged to be relatively weak.[33]

In the public sector, too, the EU has invested in technical cooperation with China in areas where both sides appear to have a common interest, such as in the development of technologies to improve sustainability and resource efficiency, including environmental technologies, measures to mitigate the effects of climate change, or alternative energy. Cooperation in the areas of innovation and research are less developed because of reservations on the EU side about the wisdom of collaboration with China before essential safeguards concerning intellectual property rights (IPR) and the rule of law in China are in place. The EU has made reciprocity in research opportunities and a clear EU interest in cooperation a condition for the participation of non-EU countries in the 2014–2020 EU Research and Innovation Programme, Horizon 2020, which may affect relations with China.[34]

Seen from the European side, the longer-term potential for EU–China technical and research cooperation is considerable. China is moving into the world's mainstream in addressing climate change and environmental issues (in such areas as sustainable industrial production and consumption, alternative energy, transport, and urbanisation) and in confronting the social and health challenges of an ageing population. A fuller commitment by China to engage in two-way research cooperation could have a major impact. Sharing the intellectual potential of a well-educated and hard-working

population of the size of China's in the hunt for innovative ideas and practice would be of great interest to European governments and companies. In practice, however, European authorities and companies cooperate less with China than with many other partners, and EU–China cooperation programmes rarely result in company-level joint ventures. Closer analysis of experience over the past decade suggests that there may be systemic obstacles to such cooperation.[35]

### *The Impact of Closer EU–China Economic Relations*

The development and enlargement of the economic relationship between Europe and China has affected the economies of both sides. International exchange has brought benefits, in the form of faster economic growth, improved economic performance in particular industrial sectors and greater consumer welfare, but has also led to industrial restructuring and loss of jobs. For China, above all, economic re-emergence has generated enormous social and environmental change that continues to impose high costs.

It is impossible to isolate the specific effects of EU–China economic relations from those of other economic trends and developments, both international and domestic. China is not the only low-cost exporter of consumer or producer goods to the EU, even if it is dominant in many sectors. The difficulties encountered by European manufacturers competing with imports from China may have been exacerbated by indigenous factors, such as high labour costs, inflexible labour markets, insufficient innovation, or a scarcity of well-trained engineers. Size matters, however, and because of this, the EU and China exert leverage on each other's economies.

For the EU, rapidly growing trade with China has brought a number of benefits. It has increased the standard of living of European consumers, who have saved money through purchasing cheaper Chinese clothing, toys, and electronic goods and then spent their surplus income on other goods and services. The same process has reduced the level of EU inflation, which, in turn, has encouraged economic growth by keeping interest rates lower and favouring investment. Access to a wide range of consumer goods produced in China at significantly lower cost than in Europe has accelerated growth of the market for these goods, which, in the case of information and communications technology products, for example, has stimulated wider use of those products within the economy, bringing gains in facility and efficiency.[36]

The spectacular growth of the domestic Chinese economy in the first decade of this century has created new opportunities for EU companies. Global demand for products in which the EU is competitive, such as motor vehicles, fashion goods, pharmaceuticals, or passenger aircraft, has grown by nearly a third in the past two decades as a direct result of China's re-emergence and continual high growth. The profitability of many European companies has been largely based on that growth. Some well-known European fashion goods companies owe between 20 and 40 % of their global sales to Chinese nationals inside and outside China.[37] EU-based companies in the luxury motor vehicles sector, such as Jaguar, Land Rover, or Bentley, generate more than half of their pre-tax profits on the Chinese market.[38] Some European carmakers, such as Volkswagen, produce as many vehicles in China as in their home market.

There have, however, been costs. Traditional labour-intensive industries, such as ceramic tableware, furniture-making, lace-making, or book printing, have virtually disappeared in Europe, undermined by Chinese competition. Many more European industries have had to change their focus of activity as a result of exposure to Chinese imports, moving to specialised production on a smaller scale and leaving mass production of basic goods to the Chinese firms (textiles and clothing, electrical and electronic products, steel and non-ferrous metals, shipbuilding, chemicals). Much of the Chinese production exported to Europe, however, has been ordered and sometimes even financed by European producers. This has particularly been the case for manufactured goods not directly destined for the consumer, such as industrial parts and components.

Economists tend to take a positive view of the restructuring induced by international trade. Competition from more efficient producers in China and elsewhere has forced European businesses to adapt, to move from less efficient to more efficient activities or from manufacturing to service industries, both of which have contributed to higher productivity and consumer welfare. The adaptation process itself generates costs in the short term, however; governments may have to provide support for the unemployed, promote training in new skills, and help to develop an economic environment that can provide new jobs, usually through encouraging the growth of small business.

The economic impact on China of its new relationship with the EU has also been significant. The EU has provided a large, wealthy and, until recently, dependable market for Chinese exports, which has grown steadily until 2008 (although much less quickly than the Chinese market over the

same period) and which has remained open to trade despite the political pressure for increased protection of EU producers exposed to competition. Although the relative importance of the EU market to China has shrunk from 20 % of China's exports in 2010 to 16 % today, it is still massive.

EU companies have also invested in industrial sectors that have been important in China's economic development, such as chemicals, pharmaceuticals, electrical and electronic technologies, food processing, motor vehicles, and passenger aircraft, and would have done so on an even greater scale if Chinese regulations had not prevented them. That investment has provided hundreds of thousands of jobs in China, has helped to train the Chinese workforce and improve Chinese management skills, and has involved a transfer of technology to China that has been at the base of China's development of increasingly competitive manufacturing companies.

A key question for the future is whether there is a risk of European disinvestment in China, or what is sometimes referred to as the "re-shoring" of business operations. The EU Chamber of Commerce in China, representing 1800 of the most competitive European companies, has emphasised that without further economic reform in China, this could become an option. Re-shoring may occur for different reasons. Generic ones might include the rising costs of production in China, especially labour costs, or the risk of losing critical intellectual property to competitor because of insufficiently reliable legal protection. Sector-specific problems might be the lack of sufficiently skilled labour, management skills or quality control, changes in production technology that make labour costs largely irrelevant, or the need to move production closer to the final consumer in order to ensure rapid adaptation of production to market requirements. One of the imminent challenges for China is to reassure foreign investors that it has the institutional and regulatory framework needed to remedy these perceived shortcomings, including an administration that will manage the Chinese economy fairly and without discrimination.[39]

## Policy Challenges for the Knowledge-Based Economy

The weaknesses and gaps in the EU–Chinese economic relationship referred to above, which will be examined in greater detail in Part II, stem partly from China's current system of political control of the economy, which gives rise to market distortions or a fear that they may develop, partly from European reluctance to cooperate with a China that does not apply the same ground rules of economic governance as the EU.

Policy change may be on the way in China. The Chinese leadership under President Xi Jinping has committed itself to extensive economic reform, most strikingly at the Third Plenum of the Chinese Communist Party (CCP) Central Committee in November 2013, at which it was declared that the market would be given a decisive role in the Chinese economy. It is possible that wider application of market economics into the Chinese economy will attenuate or possibly even remove some of the gaps and weaknesses referred to previously. A commitment to more competition, further opening of the Chinese economy, the removal of restrictions on foreign investment and further progress towards convertibility of the RMB were all mentioned in the conclusions of the Third Plenum.[40] Some of the messages of the Plenum decision were, however, ambiguous. The dominant role of the state in the economy and the preservation of a significant role for SOEs was repeated throughout, and the general language of the policy declaration suggested that internal debate within the Party on the most critical policy issues was not yet over. Some key issues, such as the rule of law, hotly debated in China, overlap with political reform that has been ruled out by the Chinese leadership. Scepticism about the CCP's willingness or ability to deliver key parts of the announced economic reform programme may therefore be justified. [41]

Whatever the future intentions of the CCP leadership regarding economic reform, changes in industrial technology and economic and social organisation in the advanced economies will increase the pressure on China to pursue economic reform and reconsider its economic relations with the rest of the world.

In the past two decades modern industrial economies have, according to recent commentators, embarked on a "third industrial revolution,"[42] based on growing digitalisation of the economy and the development of more capital-intensive production systems, in which technologies such as informatics, computer-based design, three-dimensional printing, customisation and robotics play a large role. Manufacturing will be increasingly based on the combination of technologies and expertise in their use (such as bioscience, new materials, miniaturisation, energy efficiency and informatics) rather than on specialised, one-track expertise. This will call for a smaller but more highly-skilled labour force with the flexibility to adapt to rapid change of production systems. The company of the future will tend to combine manufacturing and service functions within a single firm, be focussed on the continual innovation and measure its performance also in terms of environmental sustainability and resource efficiency. Meeting these demands will require communication in real time between suppliers

and customers to ensure constant adaptation to market needs and access to new knowledge from outside sources as the basis for economic activity.

Governments in developed economies are now concerned to provide a regulatory and policy framework that promotes this knowledge-based economy, in particular by improving the efficiency of markets, communications, and education and research systems. In parallel, they are promoting environmental sustainability and resource efficiency through market-based measures.

Measures of this type have been agreed within the EU as part of its strategy to recover from the 2008 financial and economic crisis and achieve long-term competitiveness and economic growth. They include the Europe 2020 Strategy for Growth and Jobs agreed in 2011, the Digital Europe programme proposed by the European Commission in 2014, a new industrial policy agreed in 2013, as well as the programme agreed in 2011 on mitigation of the effects of climate change and the development of alternative energies by 2020.[43] A significant part of the EU's budget over the period 2014–2020 for research, innovation, education, regional development and industrial policy has been allocated to these goals. Future measures related to this agenda include the development of financial markets better placed to identify and support innovative firms; providing education systems adapted to lifelong learning; ensuring minimal state interference in communications, including social networks; more flexible labour markets; reliable legal protection of IPR; policies that minimise external costs to business and society from pollution, waste, or regulatory costs; and improvement of transport and communications infrastructure through high-speed rail, computerised container transport, or high-speed broadband networks.

The USA, although less committed to government intervention in such areas as climate change, environmental protection, and energy than the EU, has taken the initiative to focus regulatory attention and budgetary spending on the promotion of industrial innovation.[44]

It will take time to achieve these objectives. Some of them imply significant costs, in the form of investments in communications and transport infrastructure, for example, or in terms of adjusting education, training and social security systems to take account of more flexible labour markets, labour mobility, lifelong learning, and recurrent retraining. Public spending constraints mean that the private sector will have to share the investment burden with governments.

China can already compete with the rest of the world in several of these policy areas. It has the financial resources to invest heavily in emerging technologies and both its 12th and 13th Five-Year Plan provide for that.[45] It has a relatively unregulated labour market, and its impressive investments in transport and communications infrastructure have been one of the main drivers of its rapid economic growth. It has identified the reduction of environmental costs on the economy as a priority, introducing regulations on sustainable industrial production and experimenting with different options for emissions trading, for example.

In other areas, however, China's regulatory framework and economic and social system is much further away from the paradigm needed to support the third industrial revolution. China has to catch up with developed economies in the opening up of markets to competition, increasing capital investment per unit of labour, financial market reform, education and the development of skills, the removal of constraints on access to information, and effective protection of property rights. It will also need to address the problem of the rule of law, a fundamental condition for attracting investment that is taken for granted in major economies outside China but still not assured in China.

The developed economies are not only aiming to create a more favourable framework for new forms of economic growth at home. They are seeking to promote the same goal at international level. Frustration at the failure of the multilateral trading system under the WTO to provide a regulatory framework for trade and investment in high technology goods and services has led to US-led initiatives for a new generation of regional Free Trade Agreements (FTAs) across the Atlantic and Pacific. These will include commitments to open investment, enhanced protection of intellectual property going beyond WTO rules, action against cybercrime, and the removal of technical barriers to trade (TBTs). They are intended to produce giant, secure markets for emerging technologies that will not be open to countries unwilling to commit to the new rules. One such regional arrangement that excludes China, the Trans-Pacific Partnership (TPP), has already been negotiated, subject to ratification. If others, such as the Transatlantic Trade and Investment Partnership (TTIP) between the USA and the EU follow, and China fails to carry out the economic reforms that would allow it to join such arrangements, it could become an economic casualty of regional FTAs.[46]

China is therefore under pressure to equip itself with a regulatory framework that provides incentives for innovative companies to develop

there. If it fails to respond, it risks becoming less attractive to the foreign investment and other forms of partnership that it will need to overcome its formidable economic challenges. This is what is at stake in the economic reform to which the Chinese leadership is now publicly committed.

## Conclusion

At first sight, the remarkable pace of growth of economic interdependence between China and the EU over the past 40 years presents an encouraging picture. Trade links between the two parties have grown enormously, have diversified into more substantial investment links, and have involved valuable if limited technological cooperation. Substantial improvement in the quality and depth of the China–EU economic relationship will, however, depend on each side's readiness to take more radical policy decisions than those of the past and to adopt a clearer position in regard to difficult political choices at home.

The heaviest burden may seem to fall on China, in terms of opening up its trade and investment markets and accepting the adverse political consequences, at least in the short term, of dealing with its uncompetitive enterprises and finding work for laid-off workers. Just as challenging will be ensuring the transition to a regulatory system that welcomes and protects competition, rewards investment, encourages innovation by protecting property rights, including for intellectual property, and assures the rule of law.

The detailed analysis in Part II will show that the EU's performance, too, in some of these areas is imperfect and that it suffers from a particular handicap, namely, an inability to overcome internal disagreements about economic policy priorities and an apparent reluctance to act as one in its external economic policy. Competition between the Union and its Member States for competence and influence can be an obstacle to defining a clear EU strategy towards China and, even where such an EU competence exists, to carrying it out effectively.

Before moving to that analysis and identifying the political obstacles that will have to be addressed before EU–China economic cooperation can assume anything like the spread and depth of, say, EU–US economic interaction, the following chapter will examine the international context in which EU–China relations develop, and describe in particular the EU and Chinese perspectives on the governance of global financial and trading systems.

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CHAPTER 3

# The EU and China in the Governance of Global Financial and Trading Systems

*Key questions:*

- *How is the multilateral system of economic governance evolving to take account of China's global re-emergence?*
- *Do Europe and China have conflicting or compatible views regarding the framework of rules governing international economic activity?*
- *How can China's engagement as a member of current international economic organisations best be characterised?*
- *What changes might China be seeking in international economic governance and what would be the implications of such changes for the EU?*

This chapter will explore the concept of global governance and show how China and the EU engage with each other in the domain of international economic, financial, and trading regulation. It will explain why it is that the global economic system is so important to this bilateral relationship and will address why and how international interactions are becoming increasingly problematic, in terms of differences in priorities, objectives, and attitudes between these two actors. It will also show how these differences may affect the changes now taking place in the international economic regulatory environment.

The EU's multilateral governance engagement with China is currently evolving in a number of important ways. New international institutions are emerging which may, over time, lead to systemic change at the multilateral level with the potential for considerable divergence in the values and

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J. Farnell, P. Irwin Crookes, *The Politics of EU–China Economic Relations*, DOI 10.1057/978-1-137-48874-9_3

operating principles upon which these new arrangements are based.[1] For example, China's role as a re-emerging power is driving a debate on how to reconcile different interests and priorities in the evolution of global governance with the longstanding US-led consensus on how the system should operate, who should be its leading decision-makers, and how to resolve what "[m]any Chinese" see as "fundamental defects in the international system."[2] Concurrently, the EU's philosophy is to continue to prioritise what has been termed "effective multilateralism," offering a very distinctive view of drivers of the system as a whole, not all of which are shared by the USA, let alone the People's Republic of China.[3] This vision of effectiveness collides with China's long-held views on the need for multiple poles of power within the global system to operate in tandem with a rather looser framework of multilateral decision-making and a lighter-touch attitude towards rule setting. Such differences in the underlying principles of international engagement exacerbate tension in the bilateral relationship between the EU and China in a number of policy domains.

Despite some progress being made towards enhanced cooperation between China and the EU in the global sphere, especially in banking regulation, deep discords persist. It is within this complex set of interdependencies and distinctive positions that the EU's bilateral relationship with China must be located and explored.

## The Contemporary Evolution of Global Governance

Global governance does not mean government in terms of a single authoritative entity. Instead, it refers to an evolving system of agreed rules and a network of intergovernmental and international institutions that together shape policy across a wide range of issue areas within a framework of state and non-state actor relationships, often characterised as a complex collection of differentially constituted regimes.[4]

The EU and China are visible in all of the major institutions of global governance and have tried to build a constructive working relationship within them. For example, both have recognised the importance of agreeing on global solutions to solve particularly intransigent global problems, and they value the role of the United Nations as the final arbiter of conflict resolution. However, in terms of specific procedures and priorities, they disagree on a number of issues, such as the pace and extent of institutional change, the role of the G20 group of nations as a future

decision-making body, and the extent of authority that institutions should have to regulate decisions behind national borders.[5]

There has been rapid expansion in recent years of the number of agencies and organisations tasked with economic management at the global level. These regulatory structures have been criticised, most pointedly by a research panel of the United Nations Economic and Social Council, as exhibiting "a deficit in coherence and consistency within the existing international monetary, financial and trading systems."[6] Chinese endeavours in recent years have been, and are likely to continue to be, focused on regulating future institutional expansion in ways that change existing decision-making norms so that they better match China's own national interests rather than only those of the USA and EU.

There is now greater fluidity in the determination of priorities and preferences at the global level than in previous decades, creating what has been termed a "global multi-level governance paradigm."[7] These developments have included new regional cooperative models—for example, closer links between the Association of South-East Asian Nations (ASEAN) and North East Asia through ASEAN+3 and the entering into force of the ASEAN Economic Community (AEC) on 31 December 2015—as well as new agreements on investment and monetary cooperation between states that operate outside the control of existing institutional structures. In this era of change, evidence strongly suggests that China is seeking to secure its own "geopolitical strategic rights" as an actor of global significance, for example, in Central Asia security cooperation through the Shanghai Cooperation Organisation (SCO), in Asia-Pacific trade negotiations such as the Regional Comprehensive Economic Partnership (RCEP), and in the AIIB.[8] Concurrently, the USA and EU are focused on defending their own distinctive and long-established positions as both economic powers and the structural designers of the post-war institutional framework.

The EU's response to these evolving conditions has been variable depending on the regime concerned, on the one hand forceful and determined in defending its interests in global institutions such as the WTO and the World Intellectual Property Organisation (WIPO), whilst on the other standing accused of being inhibited and inchoate in its dealings with regional bodies such as the ASEAN Regional Forum (ARF) and the Asia–Europe Meeting (ASEM).[9] The EU tries to use its engagement at the multilateral level as an extension of its emphasis on projecting its own values in seeking to bring about behavioural change in states that it regards as not operating in accordance with European ideals. Its strategy is therefore

focused on ensuring continuing influence over the direction of change in economic governance structures, whilst simultaneously re-establishing stability within its own regional fiscal and banking regulatory arrangements. This has meant maintaining an emphasis on sustainable growth policies within the Union, promoting EU-level external competences in the economic field in relation to its Member States and reinforcing the decision-making authority of the EU's central institutions.[10]

China's goals at the global level reflect the agenda of a re-emerging rather than an established power. The country's political elite need to balance the demands of domestic economic development and Communist Party legitimacy with a desire to reform the authority, accountability, and structure of international institutions. The country's engagement model is predominantly interests-driven rather than one based on projecting its domestic values internationally, although the Chinese leadership is increasingly taking the view that many of the country's interests could be more effectively served by a global system whose operating principles reflected China's own behavioural norms more than is currently the case. As China grows in confidence and its capacity to shape policy grows across different regions and within international institutions, the country looks set to project its own operating standards into rules-setting processes.[11]

The EU and China thus have different views on how to shape the character of the global economic governance system, and both need to mitigate the risk of possible negative outcomes from the future evolution of the system. The characteristics and implications of each side's engagement model will be examined in the remainder of this chapter.

## The EU and Global Economic Governance: Characteristics, Challenges, and Objectives

### *The EU's Promotion of Effective Multilateralism*

The EU has been at the forefront of promoting multilateralism as the key underlying principle for constructing the basis of global governance by institutionalising international cooperation. What marks out the Union's approach to multilateralism as distinctive, as compared to the USA and in particular to China, is the strongly held belief—even if not explicitly articulated in its founding treaties—that multilateralism is required in and of itself for the successful evolution of governance, as a basis for defining binding international rules, as a framework for decision-making in specific issue areas, and as a platform of legitimacy for enforcing decisions once made.[12]

After all, the EU is itself a collective actor by design whose commitment to pooled sovereignty, majority voting, and legal enforcement of decisions across a wide range of collective competences establishes its credibility as a sponsor of multilateral principles. It is therefore no surprise that the EU has been an active voice at the United Nations for many decades and that, since 2011, its status as an enhanced observer has enabled the Union to speak at both the General Assembly and Security Council to further what the EU regards as its distinctive philosophical contribution.[13]

First mentioned in a European Security Strategy document in 2003,[14] the underlying rationale for "effective multilateralism" can best be captured from Article 21 of the Treaty on European Union (TEU), which states that one of the key guiding principles of the EU's foreign policy shall be to "promote multilateral solutions to common problems" and to pursue policies that support "an international system based on stronger multilateral cooperation and good global governance."[15] This bedrock of EU engagement is wholly in keeping with the Union's self-identity as a normative power within the international system, projecting its fundamental values at all levels and seeking convergence between these values and the operating behaviour of multilateral institutions of which it is a member.[16]

This is also the motive for advocating respect for the principles of international law that underlies the EU's agenda, where rules-based behavioural boundaries are agreed and determined, both to tackle global problems and also to act as a constraint on unilateral state action. In essence, what the EU seeks to do in its support for effective multilateralism is to embed its own particularity of a sovereignty-limiting system into the realm of global order.[17] In so doing, the EU seeks an expansion of multilateral solutions to tackle global issues as the best option for peace and stability, within a framework that promotes the rule of law and respects human rights as defined in the European concept of civilisation.[18]

### *European Policy Challenges*

The EU's sometimes evangelical advocacy of these principles has, however, encountered challenges from two different quarters. One is internal and linked to structural problems within the EU's own decision-making. The other is external, wherein Europe now faces competing centres of power within the institutional system, such as China, whose political leadership is also seeking to influence the development of systemic norms but which may not share the EU's blueprint.[19]

The special nature of the EU's structure means that it can be difficult to operate as a single actor with the same efficiency and effectiveness as a unitary state. The Union's project to institutionalise sovereignty pooling among its Member States regularly encounters obstacles—in particular in the field of foreign policy, which emerged from the Lisbon Treaty negotiations as a special competence, with shared roles and equal visibility for the EU's newly created foreign service (the EEAS) and Member State ministries. At key moments, national-level interests can diverge from Union priorities in ways that hinder effective EU-level action and coherence. For example, on the issue of solar panels and anti-dumping disputes with China, Member State intervention (in this case led by Germany) effectively curtailed EU trade defence action sanctioned by WTO, despite specific Treaty provisions on Community competences which confirm that the EU speaks for all with a single voice in matters of trade policy. The story is similar in respect of trade disputes over Chinese subsidies. The Union's ability to construct a unified position concerning China is often inhibited by internal differences of interest and policy even within global forums covering areas which might properly be considered fully devolved Community competences, as will be discussed further in Chap. 4.[20]

Externally, the EU faces equally significant difficulties. For example, effective multilateralism directly challenges long-held views across East and Southeast Asia of the importance of sovereignty as the basis for dialogue between states. Such a tenet is encapsulated in the founding principles of ASEAN's Charter, for instance, which states in Article 2 that its members shall "act in accordance with … respect for the independence, sovereignty, territorial integrity and national identity of all ASEAN Member States" whilst also demanding "abstention from participation in any policy or activity … which threatens the sovereignty territorial integrity or political and economic stability of ASEAN Member States."[21] The contrast with the spirit of the Treaty on European Union (TEU) is striking.

Most particularly, the EU's multilateralist vision collides with the emerging image that China presents to the world as a major power with its own normative agenda. The Chinese take a very different view from that of the EU: the country's embrace of multilateral principles is more limited and interest-led than philosophically underpinned. Defence of state sovereignty continues to be the driving principle of China's participation in the international system and, whilst it would be wrong to ignore China's recent rhetorical support for multilateralism, the strategic objective of this discourse is to provide international stability for China's own re-emergence

whilst restraining American unilateralist actions that could harm China's regional and global interests.[22]

China is seeking what might be best termed as practical engagement for particular purposes at the global level, or "functional multilateralism."[23] Examples of this approach can be seen in a number of China's strategies: in the G20 in respect of re-establishing global financial stability to protect balanced growth and sustain employment, or at the United Nations Security Council as a constraining voice in debates over the legitimacy of international intervention through upholding its own "Five principles of Peaceful Coexistence."[24]

Intra-EU difficulties in developing a coherent response to these trends have often been intensified by competing internal priorities. Key Member States such as Germany, for example, have seized the opportunity to use meetings such as the G20 to further their own economic interests through cooperation with China. For example, China and Germany successfully led opposition to plans put forward at the Seoul G20 meeting in November 2009 to impose numerical limits on current account surpluses, whilst they have both also consistently presented a united front against the use of quantitative easing (QE) by central banks, unified in their criticism of both the US Federal Reserve and the European Central Bank (ECB).[25] The two economies formalised bilateral support for their cooperation through the creation of the China-Germany High-Level Financial Dialogue, which held its first meeting in March 2015.[26]

### *Contrasting Objectives over the Shape of Power Politics*

Coupled with disjointed European behaviour, there is growing evidence to suggest an increasing self-confidence within China's political elite in the country's ability to project its own norms at the global level as a basis for building alliances across Central Asia, Africa, and Latin America, promoting ideas such as the role of the state in national economic structure, the primacy of society over the individual in defining human rights as material principles rather than political pluralism, and the need to shift the global order away from US-led hegemony towards regime-neutral international institutions.[27] All of this is a direct challenge to the EU's blueprint for international society.[28]

Exacerbating these differences are those that exist between the EU and China over the role that multipolarity should play in contemporary international relations.[29] There is clear evidence to suggest that a world in

which power can be more effectively balanced between different poles within the international system continues to be an objective for which the Chinese are striving and one to which they believe the EU should make a more important contribution, independently of the USA. China's objective is to balance the hegemonic power of the USA, whilst the European objective is to co-opt the hegemon into embracing the EU's engagement principles.[30]

Whilst recognising the drift towards a multipolar world order in recent years, the EU maintains that such moves should be firmly resisted because they are dangerous.[31] In the first place, they imply a return to international relations that encapsulates what leading EU figures see as a nineteenth-century view of power dynamics, with all the instability and risk of conflict that such an approach precipitated in the first half of the twentieth century. In the second place, an emphasis on multipolarity risks a return to the bipolar relations that undermined stability and threatened peace for decades during the Cold War after 1945. European political architects put forward the strongly held view that it matters far less how many poles of power exist but instead under what rules they operate.

Whilst the Chinese have repeatedly rejected any description of the evolving international order as a prototype for a G2 relationship between China and the USA, the EU has also rejected any moves towards a G3. It is difficult to see how these competing visions can be reconciled and friction becomes ever more likely as each side promotes its own set of principles for a global system of governance.[32]

## China and Global Economic Governance: Securing Interests as a Re-Emerging Power

### *Simultaneously Revisionist and Status Quo?*

China has been re-emerging into the international state system over the last 35 years. Traditionally, an emerging power's attitude towards the current system and its willingness to operate within its constraints were bifurcated into two very different categories. On the one hand, there was the attitude of a revisionist power, implying that the state in question would likely seek reform, or even the overthrow, of the current system. On the other hand, a status quo power was typically characterised by broad acceptance of present conditions and a willingness to work within existing institutions and to abide by current behavioural norms. This raises the question: What kind of power is China?

China's engagement strategy has typically been assessed by analysing the number of different global organisations that it has joined and considering its attitude within such organisations. Under this fairly straightforward categorisation, China has been shown to have been broadly constructive and positive in its engagement in a number of major international organisations, such as the WTO, WIPO, and the World Health Organisation (WHO), to name three where Chinese nationals have held leadership positions and where the People's Republic has consistently taken an active part in policymaking.[33] China is a member of over 130 different international bodies, contributes towards numerous peacekeeping operations, and supports EU and US forces in anti-piracy deployment in defence of freedom of navigation in the Indian Ocean.[34]

However, recent research is challenging the simplicity of this analytical framework. China is now perhaps better understood as an exemplar of a new kind of engagement that can be both revisionist and status quo simultaneously, seeking to shape both the norms and structures in some issue areas whilst content to participate more passively in others. Such an approach is compounded by changing behavioural patterns over time. An emerging state may build capabilities to project principles based on its own viewpoint in such a way that they can influence the evolution of thinking in particular policy areas, for instance by acquiring the operational experience necessary to become more confident in asserting its own perspective whilst simultaneously becoming more capable of negotiating desired outcomes. In this way, working within existing institutional frameworks can become an acceptable method of both maintaining stability at the global level whilst also influencing the development of behavioural standards and future structures.[35]

China's priorities in economic decision-making are heavily influenced by its domestic political realities. The legitimacy of the Communist Party is intrinsically linked to the domestic grand bargain made with the Chinese people since the start of China's reform and opening, wherein financial prosperity, economic development, industrial modernisation, and societal rejuvenation were to be delivered in return for an acceptance of the CCP's political supremacy and an absence of meaningful pluralism outside Party control. Nothing published in the proceedings from the Third Plenum in December 2013 seems to change this approach at the strategic level.[36]

This has been consistently part of a Chinese approach to achieving what it has termed the socialist market economy system. Nevertheless, fault lines persist across China's economy that may well constrain its capabilities at many levels: export dependence in sectors often dominated by foreign firms,

an over-reliance on public sector investment rather than consumer spending to support growth, a relatively weak financial market, and limited levels of internationally competitive scientific innovation are just some examples of these weaknesses that the Party's reform agenda will have to tackle.[37]

China's principal economic concern at the global level is, therefore, maintaining stability, whether in the form of monetary systems, trading mechanisms, financial markets or banking networks. These priorities also shape the patterns of Chinese engagement, helping to explain the country's visible presence in international organisations and the way that such a presence is exercised. China has called for a greater voice in the strategic direction of financial regulation and has shown its preparedness to exercise leverage as a trading power in negotiations at the WTO. Such activism inevitably brings with it an increased risk of collision with established actors such as the EU and the USA.[38]

### *Chinese Attitudes to the Future of Global Economic Governance*

A more plurilateral network of economic partnership agreements appears to be emerging in the second decade of the twenty-first century that may have important implications for the evolution of the institutional architecture of the international economic system. For example, success in finalising negotiations for new forms of regional trade agreements, such as the US-led Transpacific Partnership (TPP) and the US–EU TTIP could undermine the existing global system overseen by the WTO. Whilst there remain formidable issues to overcome before these new agreements materialise, such an outcome could impact the power positions of major trading nations such as China, as they will face the need to navigate new relationships, understand new rules, and build new alliances. China's need for stability at the international level as a re-emerging power still focused on domestic economic development may make it rather more status quo-oriented than either the EU or the USA. This new generation of trade agreements could require far greater levels of conformity to largely Western-led legal and regulatory norms than China may be prepared to accommodate.[39]

Moreover, the definition of what constitutes the norm for future trade agreements may be fundamentally shifting towards regional agreements such as these that penetrate deeper into behind-the-border harmonisation. Such developments profoundly worry China.[40] Concerns about initiatives that may weaken control of international trade policy in existing institutions

and so diminish Chinese power in a future fragmented regulatory landscape have been debated within Chinese policy forums. For example, in September 2013, a meeting was convened of Chinese experts from the Institute of European Studies (IES) of the Chinese Academy of Social Sciences (CASS) in Beijing to analyse economic issues in EU–China relations, during which there was frank discussion of the serious implications for China of both of these potential new trade accords. In a related move, Chinese trade diplomats at a meeting in Geneva in December 2013 indicated their willingness to become involved in future deals as a hedge against potential failure of WTO talks at the multilateral level.[41]

China also perceives that it has had insufficient recognition as a re-emerging power within global institutions of economic governance and has continually indicated concerns over the structure of international economic institutions and their internal management that appear to perpetuate a Western-led power relationship at its expense.[42] At the structural level, there is Chinese concern, shared by many developing nations, that authority to make decisions and control outcomes in international economic institutions is too heavily weighted in favour of established Western powers and that greater account needs to be taken of alternative viewpoints in policy formulation. The creation of the China-led AIIB shows the Chinese leadership's manifest dissatisfaction with the continued dominance of economic governance by the USA and EU to the detriment of China's interests.[43]

China has also repeatedly stated that the G20 should become less of a crisis management forum and more of a platform for comprehensive international cooperation with greater legitimacy as a result of developing and emerging country representation. In contrast, the EU and the USA have been largely silent on these wider concerns and together promote a list of objectives for the forum that reflect a narrower view of the G20's purpose.[44]

In terms of policy specifics, China has been troubled at the support by the US Federal Reserve and ECB for quantitative easing as a way to primarily benefit some national economies rather than the global economic system. Given that these initiatives are seen by Chinese decision-makers as remedies for a financial crisis that grew more from Western regulatory failure than from any inherent weakness in China's own economic model, there is disquiet in elite circles about the applicability and imposition of Western-sponsored solutions at the global level. A greater balance of power at the global level is a key Chinese objective.[45]

## Current Policy Engagement by the EU and China in Economic Governance

The Chinese and Europeans seek to interact within global bodies in a constructive spirit of engagement. However, the differences in outlook already highlighted affect dialogue between the two sides and can result in sharply diverging visions of how international economic and financial institutions should evolve. As China grows in confidence and refines its ability to both marshal its own power internationally and assemble alliances of states to support its position, such tensions are likely to increase.

Three areas of high political salience to both Europe and China will now be examined in more depth as examples of these tensions: the international financial system, banking regulation, and the trade system.

### *The International Financial System*

As states seek to design a system that can reduce the risk of shocks to the global economic system such as those caused by the post-2008 financial crisis and recession, one of the main themes for reform has been the need for greater institutional coordination between the international and domestic level, recognising that modern financial systems cross borders and present a major challenge to national fiscal, monetary, and social policies. Solutions have been proposed in two areas: first, coordination within international regulatory bodies, such as the IMF and World Bank, in order to build more coherent responses to international financial activity; second, a strengthening of behind-the-border controls in domestic banking regulation, including capital adequacy requirements, risk management, and reporting systems.

The EU and China have been at the forefront of these negotiations, as the impact of the crisis on both economies has uncovered inherent weaknesses in their financial markets and broader economic governance. For the EU, this has meant a markedly more active role within the Eurozone for central EU institutions, in terms of monitoring, reviewing, and rule setting, including in fiscal areas hitherto seen as the exclusive preserve of Member States. At the global level, the European Commission and ECB have established close working links with the IMF to create a new kind of regulatory coordination on issues such as risk management strategies for public debt and bailout conditions at the Member State, EU, and global levels.[46]

For China, long-delayed progress over two key elements in the international monetary framework—voting rights within the IMF membership and executive board composition changes—has reinforced its concern about the reluctance of established powers to support change in the systemic decision-making architecture. These two issues were originally separate objectives, although in the past they have been interlinked by both China and the USA in both symbolic and political terms. Progress has finally been made on implementing voting reforms originally agreed in 2010, as long-awaited approval for these new arrangements was finally passed by the US Senate in December 2015.[47] A rather more interesting issue is whether these reforms will assuage Chinese concerns over continuing imbalances in power dynamics in the institutional architecture of the current system.[48]

China's relationship with the World Bank has also been subject to tension, more particularly because the country has now become a leading creditor, in particular towards developing Asian states and across sub-Saharan Africa. Chinese engagement in this region has both political and economic objectives, reflecting the desire of a re-emerging power to forge alliances through building a network of supportive states, to expand export markets for domestic businesses in manufacturing sectors, and to develop reliable energy sources to safeguard China's own development. In achieving this latter objective, China has been described as "mercantilist," adopting a model that prioritises resource extraction to the point of a "tunnel vision of Chinese commercial interests without combining them with the political, economic and social interests of the local people," with Chinese enterprises being supported by Ministry of Commerce (MOFCOM) strategies that direct financial support to those countries that can best sustain China's national priority of economic growth.[49] Such lending is frequently directed to resource-rich countries whose political systems are regarded internationally as authoritarian and corrupt, such as Sudan and Zimbabwe, both of which have been recipients of loans offered at preferential rates for development projects.[50]

Recent analysis has estimated that up to US$ 67 billion of loans have been granted by the Chinese since 2002 across the African region, using the resources of the well-funded Export-Import Bank of China (China Eximbank)—more than by the World Bank itself. In a 2007 Memorandum of Understanding between China Eximbank and the World Bank, China's new role as a meaningful world donor was firmly entrenched, by setting out procedural rules and establishing general principles for "appropriate

levels of concessionality in the loan packages that are to be co-financed by China and the Bank," the promotion of sustainable development, and the definition of effective result measurements.[51] Whilst such wording implies at least partial acceptance by China of World Bank norms, there is a view that these moves also presage attempts by the Chinese to create momentum for a realignment of thinking in donor operations as part of a process of change to achieve a more Chinese approach.[52]

This trend has also been in evidence through China's strategic leadership of the recently launched AIIB, seen by many as a plan to institutionalise Chinese preferences for greater flexibility in conditionality for infrastructure lending across developing Asia. Thirteen EU Member States, including Germany and the UK, committed to become founder members of this new institution even as the USA vehemently counselled against such moves, although the European Commission has remained largely silent as officials considered whether and how best to design EU engagement with the new organisation.[53] The fact that Chinese preferences can influence European political actors to oppose US preferences is an illustration of how power has already shifted in international lending markets.[54]

### *International Banking Regulation*

The stability of the international banking system is supported at the global level by the Bank of International Settlement (BIS) which acts as the main body through which central banks agree best practice and foster international collaboration in resolving problems and agreeing appropriate solutions in banking regulation. Headquartered in Basel, Switzerland, it is the oldest international financial organisation in the world, having been established in May 1930 to promote central bank cooperation and take over the management of German reparation payments that were a product of the Treaty of Versailles (hence the name). In more recent times, its mission has been to promote effective regulatory supervision through its member central banks that participate in the Basel Committee on Banking Supervision, most notably in the Basel Capital Accord of 1988 and its successor agreements of 2004 (Basel II) and 2010 (Basel III). These accords have promulgated far greater scrutiny of bank liabilities, lending criteria, and risk assessment as the cornerstone of regulation in the post-crisis era (BIS Overview, 2013).

China's reaction to these initiatives has mirrored Europe's, in that it has been largely positive as it grapples with applying capital adequacy limits to and improving loan management within its domestic banks. Although

there were initial concerns over Chinese compliance, changes in control policies implemented by China's Banking Regulatory Commission (CBRC) have assuaged many doubts about China's determination to achieve full compliance. Concurrent with these developments, the Financial Stability Board (FSB), born out of the G20 negotiations in April 2009, introduces the prospect of further behind-the-border regulatory requirements concurrent with China's efforts to take over into its banking system the original prescriptions of Basel initiatives. In a review report published in September 2013, the BIS rated the Chinese domestic banking system as compliant in 12 of the 14 sector-specific regulations, with none of the deficiencies regarded as material.[55]

The BIS report does seem to show that China is adapting its banking regulation to international best practice. Indeed, the country may even be exceeding Basel III requirements in capital adequacy monitoring of its major commercial banks, whilst also prioritising improved risk assessment and loan management processes.[56]

The main challenge for China may be less in implementing the rules of these new accords but in changing the nature of the state's banking relationship with large SOEs that have benefited from prioritised lending based on high domestic savings ratios to the exclusion of smaller businesses and individual entrepreneurs. Such state-sponsored lending is alleged by EU regulators to be at the origin of significant sector-specific subsidies to industries such as solar panel manufacturing, wind turbine making, and paper milling.[57] It remains far from clear whether changes in China's regulatory structure will promote concomitant adjustments in the financial sector's behaviour towards different types of corporate and retail clients which is judged by China's partners to be anti-competitive.[58]

### *The International Trading System*

As will be further analysed in Chap. 4, trade is an area of profound importance to China and the EU, and domestic dynamics play a significant part in the engagement strategies of each. China has enjoyed significant benefits from its membership of the WTO through coordinated tariff reductions, institutionalised national treatment, and most-favoured-nation (MFN) trading status, all of which have enabled it to benefit from operating within a rules-based trading system. Realignments in the international division of labour have helped to fuel China's position as workshop of the world, with export-led growth in manufacturing and technology sectors, coupled with

significant state-led investment programmes, becoming the engine of China's economic transformation.[59]

European enterprises have also gained as the distribution of production processes and advanced logistics and supply chain management processes now mean that they have been able to take advantage of human resource cost reductions to relocate manpower-intensive operations overseas, and in particular to China. Whilst high-value design skills have traditionally remained within developed economies, assembly processing and distribution management have been fragmented such that geography no longer acts as a barrier. Further complexities in terms of gains and costs to local enterprises have been taking place at the sub-national level too. Firms in different parts of the EU have gained much over the last 15 years by this manifestation of globalisation, and it is this interdependence between the two since China's WTO accession in 2001 that has most characterised the political dynamics of relations between the EU, which is largely knowledge-based, and China, which is mainly manpower-based, as each has engaged in the global trade regime in different ways.[60]

Notwithstanding this strong case for positive interaction between the EU and China, trade tensions have built up over their markedly different perceptions of problems in the operation of the global regime and of proposed solutions to them. The main conundrum that permeates the politics of trade is a difference of perspective between developed and developing countries over whether the policy framework for the global regime—effectively its Grand Strategy—should prioritise free trade or fair trade. The US and EU strongly favour the former, whilst China, Brazil, India, and most other leading developing countries emphasise the latter. Impasses over the Doha Development Round, launched in 2001 and officially concluded only in 2015, centred on such disagreements.[61] These negotiations were seen by many in the developing world as a means by which fairness could be better embedded into future trade regulation in such controversial topics as subsidies and protectionism in agriculture. They were seen by most developed economies as a way to provide stronger rules-based market access alongside greater openness in trade facilitation.[62] Disagreements over objectives may help to explain how little progress was made in achieving the original goals, which in turn prompted some major developed economies into taking a greater interest in regional agreements such as the TPP and TTIP.[63]

Changes in the distribution of power within the global trading system have also been reflected in debates over the future of the global trade regime. China now operates as a powerful actor within the WTO and can

shape the evolution of future agreements or else block the development of initiatives at ministerial conferences on agricultural reforms, the expansion of services trade, the protection of intellectual property rights, and the reduction of non-tariff barriers. China maintains that its contribution to trade reform over the years should be fully recognised and that the significant concessions agreed by China prior to joining the WTO should be properly acknowledged by trading partners such the EU and the USA.[64]

Such recognition has not been forthcoming. The EU sees China as essentially a free-rider on the benefits of liberalised trade that has not fully met the market access commitments and trading reciprocity to which it originally signed up on its accession to the WTO in 2001, and which are commensurate with those already enjoyed by Chinese firms across Europe. These calls have been especially vocal in sectors in which the EU maintains a distinct competitive advantage and in which China maintains either a dominant role for SOEs or an interest in promoting a distinctive national development strategy, such as in services, especially financial services, and telecommunications.[65]

In response, and focusing on the principles of fairness and consistency, China sees the EU's regular use of WTO-regulated trade defence instruments (TDIs), especially anti-dumping levies, as a means of unfairly protecting the less efficient domestic industries of EU Member States, exacerbated by the continual refusal of the EU to grant China the status of a market economy in its use of trade defence measures against Chinese exporters as an exemplar of the EU's recalcitrant mercantilism dressed in the clothes of technical impartiality.[66] Moreover, the EU is seen as having been unwilling to recognise the nature and significance of the reforms that China maintains it has undertaken since the opening of its economy.[67]

Other WTO-related disputes such as these persist in many policy areas between China and the major developed economies. For example, in the context of government procurement, China has for more than a decade refused to accede to the WTO's Government Procurement Agreement (GPA) that sets norms for transparency and even-handedness. International efforts by the USA and EU to promote freer trade in technology products by expanding the scope of the WTO's International Technology Agreement (ITA) to promote tariff reductions on high technology imports effectively looked set to collapse in November 2013 in the face of Chinese demands to include over 140 product exemptions, but China eventually agreed a compromise that enabled a revised ITA to be adopted in 2015.[68] A US-led initiative aimed to tighten the Trade-Related Aspects of

Intellectual Property Rights (TRIPS) Agreement by seeking to harmonise intellectual property enforcement policy and sanctions, known as the Anti-Counterfeiting Trade Agreement (ACTA), became a further source of friction with China during 2013, after the Chinese expressed disquiet over trends towards harmonising intellectual property enforcement laws that fail to take account of different conditions and practices in developing countries.[69] These disputes illustrate fundamental differences of interpretation of what constitutes fairness in global trade regulation.

China sees the rationale for TRIPS protection for trade in knowledge-rich products as being less about protecting rights holders and more about balancing enforcement requirements, so as to reduce distortions whilst promoting future economic development of society through technology transfer and a reduction in trade impediments.[70] In its response to the ACTA, the Chinese therefore favoured conducting negotiations through the Council of the WTO, where they believed a broader range of interests could be included in the debates. The European Commission on the other hand, supported by major European technology firms, actively promoted the benefits of revising the TRIPS through the ACTA. In the end, EU accession to the proposed treaty was rejected by the European Parliament in July 2012, mainly due to Parliamentary concerns expressed over the protection of civil liberties of European citizens under the plans. The future for the ACTA across Europe looks now to depend upon the successful conclusion of the TTIP.[71]

The uncertainty of direction for the international trading system, given the underlying tension between developed and developing economies, is heightening the challenges facing both Europe and China in their relationship with each other and with the system as a whole.

## Implications and Conclusions

Two distinct and interlinked problem areas emerge from this review of the engagement of the EU and China in global economic governance, and both will affect their future bilateral economic relationship.

Problem area number one is the future evolution of norms in international rule setting.

The EU sees a more assertive China, with growing power to shape the evolution of guiding principles and the development of new approaches to global problem-solving, as potentially presenting a challenge to European views about how the international system should operate. China's growing

confidence and its readiness to abandon its previously low profile, particularly in economic policy, coupled with the EU's weakness in tackling its own internal economic difficulties, offers a more uncertain future with which the EU now has to deal. China, however, sees this problem from a different angle, based on its concern over having its legitimate re-emergence as a major power constrained by others. It has reservations about the structure, reach, and priorities of the international regulatory framework taking shape in response to the recent global economic crisis, viewing with anxiety the determination of the USA and EU to promote growth-inducing solutions to the problems of economic stagnation without regard to their impact on developing economies such as China's. China may have to navigate a delicate course between safeguarding its state-led model of capitalism and mitigating the risk of reduced influence, or even isolation, in the event of structural changes in economic decision-making at the global level, particularly in respect of trade. That the Chinese leadership is aware of such trends is clear: that they have formulated a coherent response is less so.

Problem area number two concerns the power of the EU and China within this evolving global regulatory system. The EU, together with its Member States in some parts of the institutional system, is seeking to preserve long-held positions at the international level at the same time as competing with its Member States for Union competence and authority in a number of policy areas. China, by contrast, is seeking to assert its right to a greater leadership role in those institutions that affect its policy priorities, maintaining that a shift in future economic power towards East Asia, with China at the centre of that re-emerging region, will need to be reflected across the whole framework of global economic governance.

The degree to which these conflicting concerns can be accommodated will influence the strategic direction of both European and Chinese policies at the international level and affect their bilateral relations. This chapter has shown that there is genuine uncertainty over the future course of key parts of the global governance system, especially in relation to trade but also to international lending and financial regulation, and has uncovered the tensions that persist between the EU and China as both economies seek to shape this course to better accommodate their interests.

It is to the specifics of EU–China bilateral economic relations (in trade, investment, research and innovation, monetary policy, and ensuring sustainability) that this work now turns for a closer examination of the prospects for their collaboration.

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# PART II

# Opportunities and Risks in the EU–China Relationship

CHAPTER 4

# Trade

*Key questions:*

- *Why does EU–China trade matter to both sides?*
- *What are the remaining barriers to EU–China trade, and how durable are they?*
- *Is technological development changing European perceptions of the need to ensure "fair trade" with China?*
- *Is EU–China trade tension increasing or decreasing?*

Trade still dominates the EU–China relationship, even if other economic issues, such as investment, or political ones, such as human rights, occasionally compete for attention.

In one sense, EU–China trade can be seen as a success story, a striking example of the impact of globalisation which has generated a massive two-way flow of consumer and producer goods and closer integration of businesses across continents, growing steadily and occasionally very rapidly until the economic recession in Europe led to a levelling-off of two-way trade from 2011. There are, however, stresses and strains in EU–China trade relations. Each side regularly complains about unfair treatment from the other. On the EU side, there is continuing suspicion that China acts as a free-rider in the international trade system, benefitting from openness in international markets but limiting access to its own. EU exports to China are restricted in many areas where Europe considers itself competitive. There are growing doubts about whether China's system of state aid to its

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leading industrial champions and exporters is compatible with fair trade, particularly in new technologies. From the Chinese point of view, the EU appears less open to international competition than it claims and it continues to treat China differently from other trade partners.

This chapter will first summarise why EU–China trade is so important to each side and then analyse the problem areas, identifying the causes of friction and assessing their relative importance and the likelihood of their being removed. In most cases, the room for manoeuvre of each side to meet the concerns of the other will appear to be small. Combined with the prospect of relatively low levels of economic growth in both Europe and China compared with the past, this inability to adapt trade policy substantially may increase the risk of a deterioration rather than improvement of EU–China trade relations in the medium term.

## Why EU–China Trade Matters

### *For the EU*

Since the beginning of the twenty-first century, China has become an important component of the EU economy and a factor in its state of health. The EU's single most important supplier of imported goods for many years, it has now become its second and fastest growing export market. In 2015, China accounted for a fifth of all EU imports (20.3 %) and nearly one-third of its imports of manufactures (29.8 %). It consumed nearly a tenth of all EU exports (9.5 %).[1]

The overall importance of China as a supplier to the EU is shrinking, as it becomes less competitive as a cheap source of manufactured goods in comparison to other emerging Asian economies. But a major share of Chinese exports consists of inputs to the manufacturing and service industries of the EU. Many European companies have entered into partnership with Chinese counterparts to reduce their own production costs and increase their competitiveness, in particular by subcontracting the production of parts or components to Chinese partners. As a result, the composition of EU imports from China has changed. Whereas in 2004, the lion's share went to textiles and clothing and manufactured consumer goods, with a lesser share for components and semi-finished goods, ten years later, more than half the total was accounted for by machinery, information technology and telecommunications equipment, and electrical and electronic consumer goods; textiles and clothing was reduced to just over 10 %. Approximately two-thirds of the EU's imports from China today are producer goods.

In parallel, China's importance as an export market for the EU is increasing. The Chinese market continues to grow faster than most others as its middle class increases in size. The prospect of further market growth in the world's second largest economy in purchasing parity terms partly compensates for the impact of remaining barriers to EU exports in some areas of the market. The EU's own economic performance since 2008, reflected in barely perceptible economic growth within the Eurozone, has made China's market even more attractive.

EU exports to China have grown strikingly since the beginning of this century, quadrupling between 2000 and 2012. In 2000, China was barely in the EU's top 20 export markets; by 2010, it had become the second. The EU's exports to China are dominated by machinery and transport equipment, including cars and parts (52 % of the total in 2015); China accounts for an eighth of world demand for EU exports in these categories. The rapid growth in EU exports to China in the first decade of this century, however, has tailed off in the second. Annual increases have been in single rather than double figures since 2012, and there have been falls in EU exports of some luxury goods (such as high-performance cars, expensive wines and spirits, watches, and fashion goods) as a result of government's anti-corruption campaign. Uncertainty in China about economic growth in the developed world, together with an unstable property market and tighter credit conditions at home, has reduced investment and demand for capital goods. European direct investment in China to meet growing consumer demand is replacing some trade in sectors such as motor vehicles, aircraft, chemicals, and fashion goods.

Nevertheless, trade with China remains critical for EU business. Despite the slowdown in China's rate of economic growth, from 10 % in 2010 to 6.9 % in 2015, current forecasts from the IMF suggest that China's growth rate will be between 5 and 6.3 % at the end of the decade.[2] China remains a key market for most European exporters and represents a significant percentage of their overall profits. Removing the significant barriers to entry to that market is a high priority.

### *For China*

The financial returns from China's exports to largely open world markets have funded China's investment in industrial production and infrastructure at home. Trade with the EU still generates a significant share of China's new wealth. The EU market was until 2012 the single most important source of Chinese export earnings, although lack of economic

growth since the 2008 economic crisis has reduced its importance as an export market, falling from 20 % of China's exports in 2010 to less than 14 % in 2014.[3] While the Chinese leadership has announced a transition to an alternative economic model for China, in which domestic demand will replace exports as the motor of growth, exports to the EU market, together with that of the USA, will influence Chinese economic growth for years to come. This explains why the Chinese leadership has insisted throughout the economic crisis on the need to resist protectionism.

China's imports from the EU also contribute directly to its further economic development. Critical capital goods such as transport equipment, information technology, advanced machinery, or measuring instruments, which constitute the greater part of EU exports today, serve to improve the efficiency of the Chinese economy and contribute to its competitiveness. EU–China negotiations for a bilateral investment agreement could, if successful, mean that EU direct investment in China replaces some of this trade, and voluntary or forced technology transfer may also reduce China's need for imports of European technology. But the historical contribution of exports of production technology from Europe has been significant.

Imports of high-quality European consumer goods also serve a more political objective, that is, meeting the aspirations of China's rising middle class. Access to these products may be seen as a component in the CCP's grand bargain between people and the Party.

## The Problems: EU Perceptions of Chinese Trade Policy

The surge in the growth of EU exports to China in the twenty-first century and the highly visible efforts of political leaders of the largest EU Member States to develop further trade links suggest that China is seen more as a trade opportunity than a trade threat.[4] The fact that China still enjoys a large trade surplus with the EU is now rarely mentioned in high-level political discourse.[5]

A number of difficulties need to be resolved, however, if the EU is to make the most of that opportunity, and if China–EU trade is to be put on a more stable footing. The priority issue, one of long standing, is the removal of barriers to EU access to the Chinese market. A second and growing concern is that of allegedly unfair competition from Chinese exporters in the EU and other international markets, as well as restrictions on the export of scarce minerals from China.

### *Trade Barriers*

Four types of trade barrier are regularly invoked by EU business in relation to China: technical barriers to trade (TBTs), restrictions on trade in services, closed public procurement markets, and uncertain protection of IPR.[6]

(a) *Technical barriers to trade*

TBTs are becoming more important in international trade as tariff protection declines. The average level of applied tariffs in the EU and US markets is now 5.5 and 3.4 %, respectively, and 9.5 % in China.[7] TBTs impose additional costs on doing business in new markets, through initial testing, certification and adaptation of products, the procedural delays in obtaining approval, and recurrent inspection and reporting obligations, as well as the risk of loss of valuable assets in the form of intellectual property. They take the form of technical regulations, i.e., legal requirements for placing a product on a market, voluntary standards that influence consumer behaviour (including government purchasing), and testing and certification requirements.

International rules under the WTO Technical Barriers to Trade Agreement (to which China is a party) aim to prevent discrimination against imported goods, but they are limited to ensuring transparency of rulemaking and standard setting. They are not designed to produce convergence in technical regulations or standards.

The EU is concerned about the content of Chinese rules and standards, the costs they impose, and the potentially anti-competitive practices they encourage. Chinese technical regulations and standards often, for example, diverge from international standards, which means that products conforming to the latter remain excluded from the Chinese market. Foreign-owned Chinese companies are not allowed to participate fully in the Chinese standardisation system, unlike foreign-owned companies in Europe. Foreign companies complain about the lack of transparency in China's preparation of technical regulations, where consultation of industry is often perfunctory and rules can be changed at short notice. Compliance with Chinese technical regulations and standards usually has to be verified by official bodies in China, rather than through less burdensome procedures widely applied elsewhere, such as using the manufacturer's test results or those of independent testing and certification bodies in a foreign country. The foreign manufacturer may also be required to disclose commercially sensitive data under an official approval procedure that could be disclosed to competitors.[8]

These practices in China have been particularly obstructive for information technology products, medicines, foodstuffs, and cosmetics. But they are not unusual in international trade, even if in a market the size of China's they have a serious impact. The EU regularly (and fruitlessly) complains to the USA about its deviation from international standards and imposition of local testing for motor vehicles and electrical products. China is slowly coming into line with international practice as it attempts to streamline its own bureaucracy in order to encourage domestic-led economic growth, by simplifying its mandatory certification system and accepting manufacturers' or foreign test body data in some cases. Parts of the Chinese government recognise that China as the world's biggest exporting country has an interest in reducing the diversity of rules and standards across international markets, and China is becoming more involved in international standardisation activity for new technologies, such as electric vehicles.

While TBTs in China certainly impose extra costs on exporting companies, and in some cases carry a risk of loss of IPR or trade secrets, there is gradual movement towards a more open approach. China does not stand out as particularly defensive in this area, and most EU companies remain undeterred by the risks. TBTs remain an irritant, but they are hardly a fundamental obstacle to market access.

(b) *Restrictions on trade in services*

Service industries are the backbone of a modern economy. In developed economies such as the USA and EU, they account for nearly four-fifths of total output and nearly the same share of employment. As China becomes a fully developed economy it will over time follow the same path, moving away from its relatively high dependence on manufacturing (still accounting for 43 % of Chinese output in 2014, now less than the share of services at 48 %) and agriculture, which still accounts for 9 % of GDP.

The lack of competitive service industries carries economic and social risks for China. Its labour cost competitiveness is decreasing, and at the same time, expectations about the quality of life in China are increasing. As the World Bank's 2012 Report on China in 2030 indicated, the development of services would provide the new jobs needed in China to replace lost jobs in manufacturing, increase economic efficiency (through more effective financial services, distribution, and transport, for example), and help to achieve social goals, such as the provision of a cost-effective health service

for all, including the rural population, or better education and professional training.[9] China is already capable of becoming internationally competitive in some niche service markets, such as IT-assisted services in Asia, or international hotel groups, but many of its service sectors are underdeveloped and tightly regulated, especially those that would have the greatest leverage on the performance of the Chinese economy. Foreign competition is subject to restrictive licensing in sectors such as education and health, and practically excluded in others, such as most financial services.

International rules about trade in services, in particular the WTO General Agreement on Trade in Services (GATS), are relatively weak and allow for very different levels of performance and opt-outs. Even within a relatively integrated economy such as the EU, there remain multiple restrictions on trade in services. Attempts by the EU and the USA to strengthen WTO rules on trade in services during the Doha Round negotiations have been frustrated by strong opposition from the developing countries, in which many service sectors are state-controlled or regarded as infant industries requiring protection. While the USA continues to advocate multilateral liberalisation of trade in services between a coalition of the willing in the Trade in Services Agreement (TISA) negotiations in the WTO (in which the EU supports China's participation but the USA opposes it), both the EU and USA are now primarily looking to regional FTAs (such as the TPP and TTIP) as a means of achieving this goal.

This conflict of interest between the EU, the world's largest exporter of services, and China, the world's largest developing economy, is exacerbated by China's low propensity to import services. EU exports of services represent three-quarters of the value of its goods exports to the USA and nearly half that of its goods exports to Brazil, an emerging economy; when it comes to China, however, the share of services falls to only 30 % of the value of goods exports, well below the average for all the EU's trade partners, including developing countries (35 %). It is hardly surprising that the EU has repeatedly highlighted this issue as a priority in order to achieve fairer trade.

China has recognised that developing its services industries must be part of its economic reform programme, but it still has to decide on how to do it. The fundamental choice is between continuing to protect domestic suppliers, including dominant SOEs in sectors such as energy, transport, financial services, health, and education, or opening up the market to foreign competition. The Third Plenum reform programme suggests some readiness to open the Chinese market gradually in such areas as financial services, education, culture, and health services.[10] Some liberalisation has

already been proposed in the health sector. But greater openness carries two major risks: It would undermine the political control of the state and Party in highly sensitive areas—especially financial services, health, and education—and it would reduce the market share and profitability of state-owned companies which are significant sources of revenue through taxation. There has been no evidence over the three years since the Third Plenum of a wish to implement radical change. And there are no specific EU–China negotiations underway on services.

Services liberalisation seems likely, therefore, to remain a major source of tension in the EU–China trade relationship. It exemplifies a collision not only between different stages of economic development in Europe and China but also different political cultures, in terms of commitment to open markets or state control. Given the depth of these differences, China is unlikely to address this issue in a manner that will make a substantial difference to its trade with the EU. As a result, the EU is seeking to strengthen its trade in services with more willing partners, with the USA through the TTIP, with other Asian countries through FTA's, and within the multilateral TISA group.

(c) *Closed public procurement markets*

Public procurement, the purchasing of goods and services by governments or SOEs, represents a significant share of the market in most economies (for example, about 16 % of total output in the EU) and a much larger share in China. Under the WTO Government Procurement Agreement (GPA), open to all WTO members but subscribed to by only 15, including the EU, the contracting parties open some of their procurement to international competition. The trade impact of the GPA is, however, marginal. Although 18 % of government procurement within the EU is subject to GPA rules, only 3 % of the value of those contracts is awarded to non-EU bidders.[11] China undertook to become a party to the GPA under the terms of its WTO accession but only opened negotiations in 2007. Three attempts to negotiate terms of accession to the GPA for China have not yielded results. China appears to be giving a low priority to opening its procurement market.

A key issue in the negotiations has been whether China is prepared to extend the coverage of the GPA to SOEs as well as government ministries and agencies. SOEs dominate key sectors of the Chinese economy, such as energy, transport, financial services, and health. In many respects, they conduct business on the basis of commercial criteria, but it is the Party

that decides on their economic strategy. The exclusion of procurement by these economic giants from the scope of GPA disciplines would significantly reduce the attraction of Chinese participation in the Agreement for other parties—hence the current stand-off.

Participation by China in the GPA will, if it ever materialises, affect only a very small fraction of Chinese public spending, but China's acceptance of even limited international competition would be significant for its trade partners. In many of the areas of the Chinese economy where public spending is highest (transport and communication infrastructure, environmental improvement, power generation and distribution, oil and gas extraction, health services), European suppliers have proved that they can be internationally competitive. European companies already act as subcontractors to Chinese companies bidding for public procurement contracts in China, but they are frustrated at being unable to compete directly.

International competition in public procurement is not only helpful in promoting international trade, it also contributes to economic efficiency in the purchasing country. Opening up government procurement in China to international competition would help to provide greater diversity of service provision and lower costs. It would save public money in a country with many competing claims on the public purse.[12] The Third Plenum conclusions on the need for greater use of the market in the next stage of China's economic development contained a passing reference to greater openness of procurement,[13] but this falls far short of indicating that China will sign up to the WTO GPA anytime soon. On the contrary, a recurrent theme of the Plenum conclusions is the continuing leadership role for the state and a protective attitude towards SOEs. The non-public sector is given an ancillary role in China's economic reform strategy. Many believe that vested interests in powerful SOEs, including the personal financial interests of senior Party members holding important management posts in them, influenced the strong support for state ownership in the Plenum.

Government procurement is a part of the Chinese market where China's willingness to open up to international competition can be easily measured. There has been no progress towards this goal since 2001 and little evidence that the Third Plenum will change China's conservative position. International pressure on the Chinese government to do more, in an area where it is directly responsible for both policy and economic outcomes, will remain high. If China were, against expectations, to open up government procurement to international competition after more than a decade of delay that would indeed be an indication that the new leadership is prepared to confront vested interests as part of its reform agenda.

(d) *Uncertain protection of IPR*

Intellectual property in the form of patents, trademarks, copyright, and other know-how is a key asset of international companies, reflecting their ability to innovate and gain an advantage over competitors. As developed economies become more knowledge-based, the protection of IPR has become more important for continued growth. Exporting companies assess markets in terms not only of potential returns from sales but also of risk to their intellectual property.

China's reputation for protection of IPR is poor, although it is probably fairer to say that its performance is variable. The most frequent complaints from European business concern the required disclosure and risks of "leakage" of exporting companies' intellectual property during official certification procedures, weak enforcement of Chinese regulations protecting intellectual property in the market place, such as failure to prevent the marketing of counterfeit products or take action against a breach of patents and trademarks, and uncertainty as to whether intellectual and industrial property rights can be successfully defended in Chinese courts.[14]

China's performance in this area, however, is defensible if one considers the context in which it is taking place. The concept of IPR protection is relatively new in China, which only joined the WIPO in 1980. China moved fairly rapidly from non-recognition of the concept of IPR under Mao to the adoption in the 1990s of state-of-the-art regulation to protect it, developed in cooperation with EU and US experts. In such a large and highly entrepreneurial economy, with a longstanding tradition of copying, overcoming scepticism about the benefit to society from protecting private IPR will take time. The development of a legally enforceable system for IPR protection in Europe and the USA has taken two centuries so far and is still not entirely complete.

The main problem for right holders in China is not the absence of rules but unreliable enforcement of them. The manpower available and the skills and experience of Chinese officials vary, both between different types of intellectual property (trademark and patent protection can rely on substantial manpower, copyright protection much less) and between regions (large coastal cities have more experienced lawyers and judges than inland regions). Decentralised administration in China has made uniform enforcement of IPR protection difficult to achieve; provincial authorities may prefer to defend employment in local companies that disregard the niceties of IPR protection rather than legal principles upheld by the central government.

The EU has campaigned for years for more effective protection of IPR in China, but on this issue, as on others, the driver of policy change is domestic political pressure. Fortunately, domestic pressure is increasing. Chinese companies are acting to protect their own IPR in the Chinese courts. The issue is no longer seen as one of protecting local interests against foreign ones. Although there is still a risk of arbitrary and discriminatory court decisions concerning the protection of intellectual (and other) property in China, particularly as Chinese courts are subject to political control, experts suggest that IPR protection is becoming more reliable, at least in the most developed coastal provinces of China, provided that companies take elementary precautions (such as registering their rights in China).[15]

Most EU companies trading or investing in China (and there are now over 10,000 of them registered with the Chambers of Commerce of the EU Member States) seem ready to accept the risk of unreliable IPR protection, after taking precautions before entering the market. Some choose to disregard regulatory protection of their IPR and rely instead on private protection of trade secrets, in particular through recruitment and personnel policies designed to encourage company loyalty. Cooperation at administrative level between the European Commission and the Chinese authorities to accelerate notification of breaches of IPR affecting small companies operating in China has also helped. So while IPR protection is still a potential risk for EU companies trading with or operating in China, and especially for smaller firms that are more vulnerable to the loss of their IPR, government policy no longer seems to be the root cause of the problem.

In this assessment of trade barriers in China two problem areas stand out: services and public procurement. Liberalising both would improve the efficiency of the Chinese economy. The Chinese leadership's economic reform programme appears to offer hints of progress, but there is no guarantee that change will come quickly, if at all, in either of these areas.

The other problems seem to be less acute. TBTs in the Chinese market are worrying for some exporters, but they are not much more restrictive than elsewhere, even if China's size makes any problem important. With respect to IPR protection, the situation may occasionally be worse in China than in other markets, but most commentators accept that it is improving and that powerful domestic drivers of change, such as Chinese companies seeking to protect their own increasingly valuable intellectual property, will ultimately benefit non-Chinese operators.

### *Unfair Competition*

The second EU concern about China's trade policy is the threat of unfair competition. The main focus is on Chinese trade practices and policy affecting the EU market, such as dumping or subsidies, but other distortions of competition, such as export credit support to Chinese exporters and restrictions on exports of raw materials from China, are also relevant.

(a) *Dumping and subsidies*

WTO rules allow member countries to defend themselves against unfair trade practices, by imposing additional duties at import to compensate for the 'injury' to domestic competitors from either dumping (exporters selling below the cost of production) or subsidies (public aid to exporters that reduces their costs of production). Two WTO agreements, the Anti-Dumping Agreement (ADA) and the Agreement on Subsidies and Countervailing Measures (ASCM), lay down rules for the assessment of dumping or subsidy and of injury, as well as the fixing of additional duty; they also provide an appeals procedure against trade defence measures.

China has for many years been the single biggest target of EU trade defence measures. Anti-dumping investigations involving Chinese companies account for nearly half of EU investigations initiated in the past five years; two-thirds of the EU's anti-dumping measures currently in force concern China.[16] As China accounts for 18 % of all EU product imports and 29 % of its manufactured imports, the incidence of dumping by Chinese companies appears to be much higher than China's share of EU trade. But, as with IPR protection, mitigating circumstances need to be taken into account:

- Emerging and fast-changing industrial economies, such as China, are likely to show a higher propensity to practise dumping than more stable developed economies. Their markets are less structured, competition is fierce, there may be a high turnover of companies, and those that are less able to compete may take pricing risks in order to survive. Japan and Korea also displayed a disproportionate propensity to practise dumping at an earlier phase in their industrial development but reverted over time to the average or a lower-than-average rate.

- The proportion of exports from China to which EU trade defence measures apply has so far remained very small—less than 2 % until 2012, although this percentage rose to 7 % if the settlement of the solar panels anti-dumping case of 2013, under which Chinese firms accepted a minimum price agreement in order to avoid anti-dumping duties, is included.

This being said, anti-dumping and anti-subsidy action against China has become a more pressing concern for the EU since 2013. The development by China of industrial technologies such as wind turbines, solar panels, or telecommunications equipment which can compete with the original producers of those technologies in the developed world, combined with a growing awareness that China's competitiveness has been brought about at least in part by a complex system of state subsidies, has led to a more politically charged debate in the EU about trade defence. Over-capacity in steel production following the slowdown in the Chinese economy during 2015 and the sharp increase in low-cost exports of steel from China that has followed have added to the attention given to dumping and subsidies cases concerning China.

Concerns about the distorting effects of subsidies go deeper, and could be more intractable, than concerns about dumping. Dumping is usually a transitional, atypical practice, resorted to by some exporters as a means of survival in a highly competitive market. State subsidies, however, represent a more structural and longer-term policy instrument, one that can distort the international performance of an entire industry. The Chinese companies that were alleged in 2013 to have benefitted from subsidies in the telecommunications sector, for example, Huawei and ZTE, are among the biggest and most sophisticated Chinese exporters, which have already captured a significant share of the global market in their sector.

China's political and economic structure gives it exceptional power to subsidise business. The Chinese state (and, behind the state, the Party) exercises direct control of most economic resources, independently of markets and the law and with limited transparency. This provides ample opportunity for direct and indirect subsidy of factors of production through a system that is complex and opaque.[17]

- Land in China belongs to the state and is allocated temporarily (usually through a lease) by local and provincial authorities. Land

may be allocated to business purposes without reference to a market price, although a notional price will be paid and additional costs (including bribes to the officials concerned) will add to that cost. The cost of land is determined politically, not by the market; if, for example, a local authority sees job creation as a priority, this will tend to reduce the price of land for a factory.

- The Chinese labour market is largely unregulated, which tends to keep labour costs lower than they would be otherwise, but direct subsidisation of labour costs is rare.
- The state-controlled banking system in China means that lending to business, especially the larger SOEs, is not based on market-determined interest rates. State-owned banks are subject to political direction in relation to credit policy, giving favourable (or unfavourable) treatment to designated economic sectors or individual businesses. Bad debts are usually rolled over rather than called in, although this policy was abruptly changed for some debtors during 2015. Smaller privately managed companies in China complain about the difficulty of obtaining credit on reasonable terms from state-owned banks and instead have recourse to shadow banking.[18]
- Compliance with regulations (on health and safety, environmental standards, or competition) also increases the cost of doing business. There is some evidence that major SOEs are less subject to inspection and enforcement of regulation than smaller companies, and that foreign-owned companies may be more harshly treated than Chinese-owned ones.[19]

It is impossible to obtain official information on Chinese state aid policy and practice or to calculate with any precision the levels of subsidy granted to individual firms. The EU Commission has failed in attempts to include state aid on the agenda of the official dialogue between EU and Chinese competition authorities. It has also raised the matter with European businesses, but has not received any complaint from a European company on which it could base an anti-subsidy investigation because of fear of retaliation by the Chinese authorities against the company making a complaint. European businesses that are active in China prefer to live with the distortions of competition they encounter from Chinese firms on the EU market rather than challenge them openly and run the risk of exclusion from the Chinese market or exposure to tax investigations or other official checks for compliance with Chinese regulations.[20]

Consequently, the Commission announced in early 2013 that it would open an "own-initiative" investigation into subsidies received by Huawei and ZTE in the absence of a complaint from an EU company. Although the Commission agreed to suspend its anti-dumping investigation in the telecommunications sector, as part of a broader agreement with the Chinese authorities on anti-dumping cases in July 2013, this anti-subsidy investigation remained open until immediately before the Commission's mandate expired in October 2014.

This high-profile subsidies investigation, strongly advocated by the then Trade Commissioner, Karel De Gucht, signalled a new determination to get tough with China. Since China's accession to the WTO, the EU had taken other isolated anti-subsidy measures against Chinese firms benefitting from subsidies, but the possibility that the Commission might conclude that the Chinese telecommunications sector, accounting for 14 % of China's total exports to the EU, benefitted from subsidies damaging to EU interests would have increased EU–China trade friction dramatically. Anti-subsidy measures are a direct challenge to the exporting country's industrial policy, a quite different matter from anti-dumping duties that address anti-competitive practices by rogue exporters.

The Commission's robust approach was not universally welcome and divided opinion among the EU Member States.

Trade defence is more subject to political considerations than other aspects of trade policy. Whereas a finding that dumping has occurred or a subsidy has been given is based on technical evidence, the assessment of injury and the need for countervailing duties tends to be more subjective, and is influenced, for example, by different national attitudes to government intervention or the benefits of a free market, different weightings of the consumer or producer interest, and different assessments of the costs and benefits of economic restructuring brought about by international competition. A number of northern EU Member States (Sweden, the Netherland, Denmark, and often Germany) are generally reluctant to support trade defence measures; other Member States, usually from Southern Europe, are more inclined to see such measures as an essential tool in EU trade policy.

The EU's growing economic interests in China add another dimension to this discussion. Member States have different views on how best to promote economic relations with China, and some of them question the wisdom of a confrontational approach in trade defence. Those most successful in exporting to China, such as Germany, which accounts for half of the

EU's exports of goods to China, prefer to maintain harmonious economic relations, even if that means turning an occasional blind eye to Chinese shortcomings in relation to competition. Others maintain that ignoring harmful foreign subsidies is incompatible with the EU's commitment to open markets and fair trade, and that taking a firm position towards China now will avoid more damage to EU industrial interests in the longer term. Most Member States sit on the fence and take a case-by-case approach.

The Chinese government has been adept at using its growing economic leverage on individual EU Member States, offering more trade with China or more Chinese investment in their country to persuade them not to support a Commission hard line on trade defence. A senior EU politician expressed himself bluntly:

> The Chinese subsidise like hell, but they also cleverly invest in the Member States, spreading their money around and weakening the resolve of the Member States concerned to take action.[21]

The opportunity for a long-awaited (some would say overdue) debate on the EU's attitude to Chinese subsidies was, however, removed by the outgoing Commission's decision in October 2014 to drop the ongoing anti-subsidy investigation, in order to provide its successor with a clean slate in regard to trade relations with China. Many on the EU side consider that the underlying problem remains: the EU's approach to state aid and that of its second trade partner are probably incompatible, and the EU should confront the issue sooner rather than later. Meanwhile those Member States that are significant exporters to China, or hope for more Chinese investment in their countries, question the advisability of basing a major trade dispute with China on the basis of incomplete or contestable evidence, with little chance of a conclusive finding.

(b) *Chinese export subsidies*

Most developed countries offer financial support to their exporters, providing export credit insurance to compensate exporters for non-payment by purchasers or providing loans to the purchasers of the exported goods. This support is a potential source of unfair competition (as subsidies may lower the cost to businesses of such support). An international agreement within the OECD, the Arrangement on Guidelines for Officially Supported Export Credits (1978) (hereafter The Arrangement), provides

that assistance must be based on an agreed minimum rate of interest. The ASCM includes this rate in its definition of export subsidies that are not automatically prohibited; in other words, compliance with the Arrangement provides a "safe haven" against WTO anti-subsidy proceedings.

China offers significant loans to Chinese exporters and their customers; its export finance funding in 2014 was estimated by the US Export-Import Bank to be US$ 58 billion, more than that of the USA and the EU Member States combined, a substantial proportion of these loans being offered at subsidised rates.[22] Since 2012, the EU has been a party to discussions within an international working group (IWG) of major providers of export finance, convened to extend the OECD arrangement to a wider group, including China and other emerging economies. Progress has been slow: negotiations have concerned only two economic sectors, and it will take years before a general restriction on subsidised rates of interest similar to that of the Arrangement can be agreed.

The EU appears unwilling to press China to align with international practice for the world's developed economies. One option would be action under the ASCM; the US administration is already under pressure to take such action. The EU debate may heat up if the IWG negotiations fail but instead they are regularly prolonged. As usual, obtaining evidence to support a WTO complaint will be a major challenge, given that data on Chinese official credit guarantees are scarce and affected EU companies are reluctant to provide hard information for fear of retaliation.

### (c) *Chinese export restrictions*

Restrictions placed on exports from China of raw materials in 2009 and, more significantly, of rare earths in 2011 have been the subject of successful EU–led WTO dispute settlement procedures. The rare earths case is the most important example.

China is rich in a number of rare earths that are used in the production of electronic components; these are also found in other areas of the world, including Europe, but the cost of mining and refining is high compared to China. Mining production in the USA closed down in the first decade of the century because of competition from China, and China had become the source of nearly all the world's supply of these materials by 2010. In 2011, the Chinese government imposed export duties, export quotas, minimum prices, and trading restrictions on rare earths, allegedly to conserve an exhaustible natural resource and to protect human or plant life

and health put at risk by mining. Some believe that a more likely reason for the measure was to put economic pressure on Japan, a major user of raw earths, to be more compliant in relation to its territorial dispute with China over the Senkaku/Diaoyu Islands in the East China Sea.

The quantity of rare earths available for export was reduced by a third, prices rose quickly, and producers of the downstream products in Europe, Japan, and the USA complained about the impact on their production. The Chinese restrictions were seen not only as destabilising for markets but also as a potential security threat, as some of the products incorporating rare earths were considered strategic. The absence of restrictions of supply to Chinese users of rare earths suggested that the measure was discriminatory and designed more to encourage greater use of rare earths by Chinese manufacturers than to conserve the resource.

The EU, supported by the USA, Japan, and Canada, brought a WTO infringement case against China in 2012. In March 2014, a WTO Panel found the Chinese measures to be incompatible with China's obligation to eliminate export restrictions and, in the absence of restrictions on domestic producers, rejected the argument that China was seeking to conserve a resource. China appealed against some aspects of the findings, but the appellate body overwhelmingly supported the WTO Panel.[23]

## The Problems: Chinese Perceptions of the EU's Trade Policy

China's complaints about the EU's trade policy are less wide-ranging than those of the EU about China's policy. Since joining the WTO in 2001, China has enjoyed relatively open access to the EU market and a fourfold growth in its exports, but that access has not been problem-free. China has identified specific trade barriers to some of its exports and complained of treatment that it considers discriminatory and inappropriate for such an important trade partner of the EU. It is also concerned that future trade agreements being negotiated by the EU may be designed to exclude China and have the effect of undermining China's position on the EU market.

### *Trade Barriers*

Chinese exporters benefit from the relatively low tariffs that apply in the EU market (except for agricultural products and food, which is not an area in which China has a major export interest) and face only a few

technical trade barriers. For example, Chinese herbal medicines may not be marketed in the EU (a problem shared with other WTO members such as India, and one that may evolve in the light of the debate within the EU on regulation of alternative medicines). Chinese motor vehicles have also not yet obtained type approval within the EU, apparently for safety reasons. These trade obstacles are not significant in economic terms.

China has made formal complaints against the EU under the WTO's dispute settlement procedure, mostly concerning EU practice in the application of trade defence measures, such as anti-dumping duties, which China considers as incompatible with the relevant WTO rules. Apart from the major issue of "market economy status," however, to be discussed below, the complaints made by China have been found to be unjustified by WTO Panels or have been rectified by the EU. The only current Chinese complaint outside the trade defence area concerns the alleged imposition of local content requirements by some EU Member States on government purchasing of alternative energy products, such as solar panels, apparently to exclude imports of such products from China. Chinese companies have no legal right to compete for EU public procurement, as China is not yet a party to the WTO GPA. EU Member States are, however, free to open their government contracts to competition from Chinese bidders if they wish, and there are a number of cases where they have done so, most notably in UK (for telecommunications and power supply), Poland (for the construction of a motorway), and Malta (for the supply of buses to the capital city, Valetta).

In short, restrictions on China's trade with the EU appear to be an irritant rather than a major issue.

### *Discriminatory Treatment*

China nevertheless considers that it remains subject to arbitrary and discriminatory treatment by the EU in trade. At nearly every high-level meeting, the Chinese side asks for a reversal of EU policy on two issues, and it is preoccupied by an emerging third issue, the future of EU–US trade relations.

#### (a) *The EU arms embargo*

The EU still maintains an embargo on exports of arms to China that it put into place in 1989, shortly after the violent repression of the democracy movement in Tiananmen Square and other areas of Beijing. China objects to the embargo as a matter of principle, considering that it reflects mistrust

of the Chinese government and that is incompatible with the EU's commitment to a strategic partnership with China. The EU reviewed the need for the embargo between 2003 and 2005 (a more detailed account of this process, and the USA's involvement in it, is given in Chap. 9) and decided to keep the embargo in place. Since then the issue has not been reopened and the consensus is that it will not be for the foreseeable future; the reinforced role of the European Parliament in giving assent to changes in EU trade policy since the entry into force of the Lisbon Treaty in 2010 makes it highly unlikely that this position will change.

(b) *Denial of "market economy status" (MES)*

A second allegation of discrimination is the EU's unwillingness to recognise that China has "market economy status" when investigating alleged dumping by Chinese companies. The WTO ADA rules allow parties to disregard price data from firms under investigation if they are established in countries which do not enjoy MES because of the absence, for example, of a market price system, audited accounts, or bankruptcy procedures. Instead, price data from producers of similar products in countries enjoying MES may be used to calculate the extent of dumping. Such an indirect method of calculation clearly raises doubts as to the validity of the price data and the reliability of any finding based on it.

The EU's arguments for not granting China MES, shared by the USA, Japan, and other WTO members, have centred on the fact that many Chinese companies, particularly SOEs, are not exposed to normal market discipline, although privately owned Chinese companies face competition that is second to none. The EU has up to now maintained that its assessment of China's position regarding MES is neutral and objective, based on technical criteria agreed in WTO. The Chinese government, on the other hand, considers that its status as a major actor in international trade and the second trading partner of the EU should also be taken into account. It argues that, following the terms of its accession to the WTO, it will have an automatic right to MES from December 2016, and that the refusal of the EU to recognise that status before the deadline is arbitrary and unhelpful.

Until very recently, EU officials affirmed that there could be no automatic change in China's status in 2016.[24] Any change would require new EU legislation, proposed by the Commission and carried by a qualified majority in the Council with the approval of the European Parliament. At the end of 2015, however, some Member States, including Germany and

the UK, were alleged to be arguing for the recognition of MES for China and pressing for a proposal in this sense from the Commission. Other Member States expressed concern at any change of the EU position, as did the USA. The European Parliament adopted a resolution strongly opposing MES for China. The political sensitivity of the issue was underlined by a number of threatened steel plant closures or redundancies in the EU, including in the UK, allegedly as a result of dumping of Chinese steel because of overcapacity in China. At the time of writing, the Commission has postponed its proposal on MES until July 2016.

The economic impact on China of the final EU position on MES may be small, as Chinese exports affected by EU anti-dumping measures account for a very small share of the total, but the political sensitivity for the Chinese side of this question, as well as that of the arms embargo, is great. As already mentioned in Chap. 3, the MES issue raises the wider issue of which states make and interpret the rules of international economic organisations. In China's view, both issues will have to be addressed before the EU can expect any significant move by China to improve trade relations, even though senior EU officials tend to play down Chinese complaints and suggest that they are pro forma rather than real.[25] Any change in the EU position, however, is likely to be arrived at only after an extended debate, which will underline varying degrees of scepticism among the Member States and among the EU institutions about China's commitment to market forces in its economic management. Other prominent WTO members will no doubt also wish to influence the course of the EU debate.

(c) *Free Trade Agreements*

The possible repercussions on China's trade with the EU of a future TTIP, combined with EU reluctance to open negotiations for an FTA with China, are considered by China as potential discriminatory treatment. China feels threatened by the creation of a transatlantic single market and rebuffed by the EU's rejection so far of its overtures for an EU–China FTA.

The first of these concerns, on TTIP, is somewhat a hypothetical problem, given the many question marks over the capacity of the EU and USA to reach any such agreement in the short to medium term, but Chinese representatives already express concern that the TTIP will over time erode China's access to the EU and US market on a most-favoured nation basis.[26]

The EU's wish to put off FTA negotiations with China may, indeed, indicate that the EU treats China differently. Over the past five years, the EU has launched negotiations for an FTA with most of its main trade

partners. Agreements have been concluded with Mexico, the Andean Pact, Central American countries, and Korea, negotiations with Singapore and Canada have been completed, and others have been opened with several Asian countries (India, Japan, Indonesia, and Vietnam) as well as with the USA for the TTIP. The ambition of these agreements varies, but each negotiation has the objective of going well beyond WTO commitments. China is so far being left out in the cold.

The EU's reaction to Chinese requests for an EU–China FTA, given most recently at the June 2015 EU–China Summit, has been one of polite caution, not excluding the possibility of negotiations but setting a condition that will not be easy to fulfil, namely, that EU–China negotiations for a bilateral investment agreement should be concluded first.[27] This would, according to the EU, provide evidence of both sides' willingness to make substantial concessions to the other before they embark on more ambitious and comprehensive negotiations. Behind this precondition, however, lies profound EU scepticism about the willingness of China to deliver what would be required for an FTA, in terms of significantly wider access to the Chinese market in key areas such as services, government procurement, or TBTs. Equally important is the nagging doubt that an FTA with China would be a dead letter without assurances of China's commitment to the rule of law and greater transparency of its state aid system. The EU side sees the need for more extensive reform in China before the basic conditions needed for free and fair trade are met.

China's concern at its exclusion from the EU's emerging network of FTAs is, therefore, like its other complaints about EU discrimination, unlikely to be resolved soon.

## Conclusion

This chapter's analysis of EU–China trade tensions and the reasons for them suggests that the situation seems unlikely to change significantly, even if incremental improvement may be possible. The justification offered for each side's trade barriers is usually economic, but at heart it is fundamentally political.

On the Chinese side, it will remain politically difficult for China to improve access for EU exporters in the provision of services or public procurement, for example, on a scale that would make a difference to the quality and depth of the EU–China economic relationship. Only tentative steps towards the introduction of international competition, case by case

and on an experimental basis, may be expected. Many in China, particularly within the Party, would see more rapid or extensive reform as contradicting the leadership's commitment at the Third Plenum to the leading role of the state and of SOEs.[28] This being said, China's defensive position is not unique. International competition in government procurement is the exception rather than the rule, and, as for services, China is only one among many emerging and developing economies that are reluctant to take on greater international obligations in an area so critical for future growth and jobs in their economies.

The situation is more promising for TBTs and IPR protection, where gradual improvement can be expected, largely as a consequence of China's own search for economic efficiency and the reduction of business costs. But progress in these areas, while welcome, would not be a game-changer for European business. It would certainly not be enough to change the longstanding and large imbalance in the EU–China trade relationship.

Meanwhile, the EU has so far been unwilling to accede to Chinese demands for a change of policy on MES, the arms embargo, or negotiations for an FTA, despite China's insistence that progress on these issues is a precondition for more openness on its side towards EU market access. On the first and third of these issues, greater openness on the EU side would be interpreted by many, both within and outside the EU, as weakening its fundamental commitment to fair as well as free trade. On the second issue, change cannot be delivered for political reasons.

This apparent impasse in trade policy may become more difficult to manage in the medium term. An EU decision to challenge China's industrial subsidy system or an agreement with the USA to establish a TTIP could constitute aggravating factors. While neither seems likely in the short term, neither can be excluded. An EU still struggling to emerge from recession may be more ready to retaliate against unfair trade practice than one enjoying steady economic growth. If the EU were to decide on anti-subsidy measures against China, however, it is highly likely in the short term that the Chinese government would not only challenge the decision in WTO but also retaliate against EU economic sectors that benefit from subsidies, such as wine and food. If the EU and USA were to grant each other preferential access to each other's markets or, at least, launch a quasi-permanent process of negotiation of common rules for trade between them in emerging technologies, China's position in its two biggest export markets would risk being undermined. While it would be difficult for China to conclude rival preferential agreements with economic

partners of anything like equivalent weight, its resentment of such treatment at the hands of the EU and the USA would delay any liberalisation of its own market to their advantage.

There is, consequently, little prospect of a lessening of EU–China trade tensions in the coming years. At best they will remain much as they are, at worst they could increase.

## Notes

1. Statistics relating to the EU's trade with China in this chapter are taken from the European Commission statistics database: European Commission, 'COMEXT: International Trade', *Eurostat* <http://epp.eurostat.ec.europa.eu/newxtweb>, accessed 2 April 2015.
2. International Monetary Fund, 'World Economic Outlook', *World Economic and Financial Surveys* <www.imf.org/external/pubs/ft/weo/2015/02/weodata/weorept.aspx?sy=2013&ey=2020&scsm>, accessed 1 December 2015.
3. World Trade Organisation, 'Statistics Database' <http://stat.wto.org/Home/WSDBHome.aspx?Language=E>, accessed 2 April 2015.
4. Since 2010, the heads of the UK, German, and French governments appear to have been as assiduous in visiting China, and in receiving official visits from the Chinese leadership, as they have in relation to their closest ally, the USA.
5. The EU's trade deficit with China reached a peak in 2010 (at €170 billion); it fell to €137 billion in 2014 but in 2015 reached a new peak of 179 billion; that means that China exports nearly twice as much to the EU as the EU to China.
6. For example, see the report European Union Chamber of Commerce in China, 'Annual Report 2013', *European Chamber Publications* <http://www.europeanchamber.com.cn/en/publications-annual-report>, accessed 2 April 2015.
7. World Trade Organisation, 'World Tariff Profiles 2014', *Annual Compilation of Bound and Applied Tariffs* <https://www.wto.org/english/res_e/reser_e/tariff_profiles_e.htm>, accessed 2 April 2015.
8. Further details on TBTs in China can be found in:
   European Commission, 'Trade and Investment Barriers Report 2014', *COM(2014) 153 Final* (Brussels: European Commission, 12 March 2014); Derek Scissors, 'The Most Important Chinese Trade Barriers', *Testimony Before the United States House of Representatives Committee on Foreign Relations* (Washington, DC: The Heritage Foundation, 19 July 2012); United States Trade Representative, '2014 Report on Technical Barriers to Trade' (Washington, DC: Office of the United States Trade Representative, 2015); Zhang Jiacheng and Lu Hongjie, 'Analyzing China

Harmonization of Technical Barriers to Trade in the EU and US Markets—Paper No. 75', *Wuhan International Conference on e-Business: WHICEB 2013 Proceedings* <http://aisel.aisnet.org/whiceb2013/75>, accessed 2 April 2015.

9. Further analysis of this point can be found in The World Bank, *China 2030: Building a Modern, Harmonious and Creative Society* (Washington, DC: World Bank, 2012).
10. See, for example, the language of Point 24 of the Third Plenum conclusions, which refer to "orderly" opening up to foreign investment in these areas: Proceedings of the 3rd Plenum of the 18th Central Committee of the Chinese Communist Party, 'Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform' <http://www.china.org.cn/china/third_plenary_session/2014-01/16/content_31212602_7.htm>, accessed 2 April 2015.
11. For detailed information on the EU's Public Procurement activities and strategy including statistical reports, see: European Commission, 'Public Procurement Strategy' <http://ec.europa.eu/growth/single-market/public-procurement/strategy/index_en.htm>, accessed 1 November 2015 and World Trade Organisation, 'WTO and Government Procurement' <https://www.wto.org/english/tratop_e/gproc_e/gproc_e.htm>, accessed 1 November 2015.
12. An account of the benefits of international competition in public procurement is given in: United Nations, 'Competition Policy and Public Procurement, United Nations Conference on Trade and Development', *Twelfth Session* <http://unctad.org/meetings/en/SessionalDocuments/ciclpd14_en.pdf>, accessed 2 April 2015.
13. Government procurement is included in a lengthy list of international negotiations to be accelerated by China in Point 25 of the Third Plenum conclusions, which suggests that no particular priority is given to it.
14. European Union Chamber of Commerce in China, 'European Business in China Position Paper 2014', *European Chamber Publications* <http://www.europeanchamber.com.cn/en/publications-annual-report>, accessed 2 April 2015—see especially the section on Intellectual Property at pp. 72–82, which gives a detailed account on uncertainties in the application of Chinese law in this area.
15. The EU–funded IPR Helpdesk, based in Beijing, publishes annual assessments of IPR protection in China and offers practical advice to small companies seeking to protect their IPR.
16. Commission Staff Working Document accompanying the 33rd Annual Report from the European Commission on Anti-Dumping, Anti-Subsidy and Safeguards, 3 August 2015, *COM(2015) 385 Final.*
17. Richard MacGregor, *The Party: The Secret World of China's Communist Rulers* (London: Allen Lane, 2010).

18. In June 2013, the People's Bank of China insisted on the need for greater responsibility of banks for the credit-worthiness of their borrowers. The fact that this was interpreted as a new policy, and led to a sharp fall on the Shanghai stock market, serves to underline how much Chinese banks and their borrowers have been sheltered from normal banking practice.
19. In August 2014, the European Chamber of Commerce in China publicly complained about the harassment of foreign companies by the National Development and Reform Commission, China's economic planning ministry, in its competition investigations, in particular the pressure put on companies to admit guilt before investigations and court cases were completed, which was widely reported in international media. See Michael Martina, 'EU Lobby Piles in on Foreign Criticism of China's Antitrust Enforcement', *Reuters Business News* <http://uk.reuters.com/article/uk-china-antitrust-eu-idUKKBN0H40SB20140909>, accessed 2 April 2015.
20. Interview with a senior European Commission official, March 2014.
21. Interview in Brussels, May 2014.
22. Export-Import Bank of the United States, 'Report to the U.S. Congress on Global Export Credit Competition' (Washington, DC: Export-Import Bank of the United States, June 2015).
23. World Trade Organisation Appellate Body, 'China—Measures Related to the Exportation of Rare Earths, Tungsten and Molybdenum', *Dispute Settlement DS431* (Geneva: World Trade Organisation, 20 May 2015).
24. Interview with a senior European Commission official, March 2014.
25. Interview with a senior European External Action Service official, May 2014
26. This point of view was, for example, widely expressed by Chinese participants at a roundtable of EU and Chinese think-tanks, held in Chengdu in September 2013.
27. European Commission, 'EU–China Summit Joint Statement: The Way Forward After Forty Years of EU–China Cooperation' (Brussels: European Commission, 29 June 2015), see paragraph 10.
28. The language of the preamble of the Third Plenum conclusions could not be clearer, "We must unwaveringly consolidate and develop the public economy, persist in the dominant position of public ownership, give full rein to the guiding function of the State-owned economy, incessantly strengthen the vitality, control power and influence of the State-owned economy." This translation of the original work usefully captures the nuances of language used by official Chinese state media. See section "II, Persist in and perfect basic economic institutions" at China Copyright and Media, 'CCP Central Committee Resolution Concerning Some Major Issues in Comprehensively Deepening Reform', *The Law and Policy of Media in China* <https://chinacopyrightandmedia.wordpress.com/2013/11/15/ccp-central-committee-resolution-concerning-some-major-issues-in-comprehensively-deepening-reform/>, accessed 1 October 2015.

CHAPTER 5

# Investment

*Key questions:*

- *What are the potential benefits and risks of closer investment ties between the EU and China?*
- *Why are direct investment flows between the EU and China so much lower than those between the EU and the USA?*
- *Why is China reluctant to open its market further to foreign direct investment (FDI)?*
- *Is the EU ready to take a common view on inward FDI, especially when it comes from China?*

Investment flows are an important feature of the international economy. They channel economic resources to areas of potential profitability for the investor and can contribute to economic development in the host country by transferring capital, technology, and skills. International direct investment flows today are huge (amounting to US$ 1.35 trillion of outward investment in 2014, or about 7.5 % of the value of world exports in that year), and they are a major driver of economic growth and development.[1]

The history of developed economies shows that international trade has been accompanied by increasing levels of FDI.[2] Emerging markets, including China, have recently begun to follow the same tendency and now account for nearly two-fifths of the world's FDI.[3] However, the growth of FDI has led to more searching questions about the rules that govern it at the international level and, in particular, the gap between the generally liberal attitude towards inward FDI of developed economies and the more restrictive approach of developing or emerging economies.[4]

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China presents this dichotomy in its most extreme form. It is the world's second largest single economy, with growing ambitions as an international investor, but is the most restrictive economy towards inward FDI among OECD and G20 member countries.

Two-way investment between the EU and China has grown rapidly in the past two decades, and encouraging that process is a priority for the EU–China Strategic Partnership.[5] Negotiations for an EU–China bilateral investment treaty (BIT) were opened in 2014. FDI is a politically sensitive issue for both sides, however, and negotiations are proceeding slowly.

China's attitude to inward investment is affected by its history: by resentment of the domination of China's first wave of industrialisation by foreign investors in the first half of the twentieth century, on the one hand, and by pride in the economic power acquired by its SOEs over the past 40 years, on the other. For the EU, these negotiations with China are the first major test of a newly acquired exclusive competence under the Lisbon Treaty (2010) to conclude international investment agreements on behalf of the Member States, which have distinct national investment policies and different views about both the benefits and risks of FDI and the particular challenge posed by investment from China. The cohesion of the EU is being challenged by negotiations with such an economically powerful partner.

The negotiations will also test the readiness of the EU and, especially, China to offer significant concessions in a politically sensitive area. Failure to conclude an EU-China investment treaty would have economic costs in itself, but it would also have implications for the entire economic relationship.

In examining the economic and political background to these negotiations, this chapter will, first, outline the reasons why companies invest overseas and the benefits and costs to host countries of such investment. It will consider the positions of both the EU and China in respect of FDI, with a detailed analysis of the constraints on inward FDI in China and the EU's progress towards a common policy on FDI. The concluding section will weigh up the prospects for an investment agreement between the EU and China. Despite the rhetoric of EU and Chinese leaders in favour of a substantial investment agreement, it appears that, yet again, political constraints on both sides, but particularly on China's, make it unlikely that a major improvement on today's imbalanced situation can be expected.

## The Economic Significance of FDI

FDI is defined by the OECD as:

> …obtaining a lasting interest by a resident entity in one economy ("direct investor") in an entity resident in an economy other than that of the investor ("direct investment enterprise"). The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence on the management of the enterprise. The direct or indirect ownership of 10% or more of an enterprise resident in another economy is evidence of such a relationship.[6]

The "significant degree of influence on the management of the enterprise" implied by FDI distinguishes it from portfolio investment, which aims at obtaining a return on assets rather than control over them.

Companies make direct investments in foreign markets for a variety of motives. They may want to secure access to assets that are unavailable or insufficient in their domestic economy, such as natural resources, including raw materials for industrial processing, energy sources, or land for food production. Such resource-driven investment was the main driver of FDI by European countries in their colonies in earlier centuries and is the dominant driver of China's FDI today. Approximately 70 % of Chinese outward FDI between 2000 and 2010 occurred outside Europe and the USA and was predominantly focussed on the acquisition of resources in Asia, Latin America, and Africa.[7]

FDI may also be market-driven. Foreign markets may offer higher profitability than the investor's home market, because of lower production costs or less intense competition. Investment may improve access to markets by circumventing trade barriers, such as tariffs, quantitative restrictions, or technical barriers, reducing the transport and logistical costs of bringing goods to a distant market, or bringing production closer to the final consumer and allowing it to be more easily adapted to changing customer requirements. EU car manufacturers have followed this approach in China with some success.

Foreign acquisitions may be a means of acquiring new technology, management know-how, or worker skills, or learning how to operate in a different kind of market, where new forms of branding or marketing are necessary.[8] Such technology- or knowledge-driven investment has been one of the prime goals of Chinese companies' acquisitions in both Europe and the USA.[9]

Globalisation of the world economy, involving the development of global supply chains and major changes in both the logistics of industrial production and the international distribution of labour, has provided a compelling incentive to diversify production. It has increased the pressure on companies to compete in all major markets, and increasing their physical presence is an effective way to do that. Larger companies increasingly consider their access to markets, natural resources, local knowledge, and technology at a regional or global level rather than a national one, and FDI has grown rapidly as a consequence. The 28 countries that are now EU Member States directly invested US$ 11 billion outside their own territory in 1973; the average figure for the five years up to 2013 was US$ 330 billion.[10] Investors in developed countries are keen to improve their access to FDI opportunities worldwide. As growth in their domestic markets has become more uncertain, this goal has assumed more importance.

A key requirement for FDI, however, is confidence in the stability of the conditions that justify the initial investment and legal protection of investments against expropriation. Governments seek to acquire guarantees about the rules that will apply to their companies' foreign investments through investment agreements concluded between investor countries and the host country. Twenty-six of the EU Member States have already concluded bilateral investment protection agreements with China. The EU is, however, now seeking an agreement with China which would extend beyond investment protection to include conditions for mutual access to the investment market—a far more ambitious objective.

FDI is potentially beneficial for the host country as well as the investor. It can be a source of growth and positive change both at the macroeconomic level and that of individual companies.

Inward FDI represents a net increase in the host country's economic assets, most obviously in the form of capital that can provide additional employment and stimulate new economic activity. But its economic impact can be wider, notably through the transfer of new technologies and skills. FDI also generates competition to which incumbent firms must adapt, not only in terms of the quality of the final product or service but also through innovative working practices, financial engineering, or marketing. In the case of services, such as financial services, transport or infrastructure services, increased competition and the improvement of productivity can produce spillover effects in other economic sectors.[11] At the level of the individual firm, inward FDI through a merger or acquisition can bring additional capital required for product development, new technology, improvement of the acquired firm's expertise, or an introduction into new foreign markets.[12]

China's recognition of the transformative power of FDI was most evident during the 1990s, under the leadership of Deng Xiaoping, who at the beginning of that decade declared:

> Our socialist economic base is so huge that it can absorb tens and hundreds of billions of dollars' worth of foreign funds without being shaken. (...) [FDIs] negative impact will be far less significant than the positive use we can make of it to accelerate our development. It may entail a slight risk, but not much.[13]

Substantial inward FDI was encouraged in such sectors as energy, raw and semi-finished materials, and communications. The impact of FDI on employment in China has been significant in all three sectors of the economy.[14] Host governments may, nevertheless, perceive some forms of FDI as a threat. As Deng himself put it, in relation to his opening-up policy, "When you open a window, fresh air will come in but so will some flies."[15]

In developing economies, host country governments such as China need to balance conflicting economic objectives: stimulating innovation and structural change through international competition, on the one hand, and, on the other, allowing domestic companies the opportunity to grow without being overwhelmed by such competition. They may wish to avoid the advantages of being a first mover in the market accruing to foreign-owned rather than domestic firms. Hence China's insistence during the 1990s on limits on the extent of foreign ownership, the establishment of joint ventures rather than wholly owned foreign companies, the transfer of technology and new skills to the local labour force, or even, in some politically sensitive or strategic sectors, the exclusion of FDI altogether. In developed economies, too, governments are concerned to protect jobs and to avoid the "hollowing-out" of national enterprises by the transfer of technology and jobs to the purchasing entity and the closing-down of local economic activity. For both sides, some forms of FDI may be a threat rather than an opportunity.

## EU and China Approaches to FDI

The EU Member States and China are both significant international investors but at different stages of development and with different priorities. The former are traditional net exporters of investment but with declining surplus resources and a growing need for inward FDI to spur their economic growth; China has until very recently been a traditional net importer of direct investment

which, exploiting its new-found wealth, has become the world's second biggest overseas investor and, since 2014, a net exporter of investment.

### *The EU*

EU Member States account for about half the global stock of outward FDI and a third of the stock of global inward investment.[16] Several of them (not only the biggest, such as the UK, Germany, and France, but also the Netherlands and Denmark) have a long tradition of overseas investment. In the past decade, three-quarters of the EU's outflows have been to other OECD countries, even if the share of investment in the largest emerging economies (the BRICS) has been growing steadily, from 2 % of the total in 2002 to 15 % in 2012.[17] Annual outflows from the EU are significant, averaging about €330 billion a year, as are receipts from them.

The situation is changing, however. Economic growth in most of the EU has stalled for the past six years. Urgent restructuring needs, including the need to renew infrastructure in transport, energy, and housing, reduced bank lending resulting from the need to improve the solvency of banks, high unemployment, and high levels of public debt, have made most EU Member States concerned to attract inward FDI as an additional source of funds. Companies in trouble following the recession have also been the target of takeovers, including from outside Europe.

The EU's policy on FDI is liberal. As a starting point, Article 63 of the Treaty (TFEU) lays down that "all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited." The following articles provide, however, that Member States are entitled to defend national security or public order by restricting FDI. Member States have therefore been able to maintain national legislation to protect these fundamental interests, subject to challenge by the Commission; 11 of them have done so. This legislation may be applied so long as it is non-discriminatory and does not amount to a disguised restriction of trade.[18]

The newly acquired responsibility of the EU to negotiate international investment agreements will require the Member States to define a more precise common position on inward FDI that goes beyond the principles of the Treaty. Member States will no longer be left to find their own balance of interest between the benefits of foreign investment and the protection of domestic employment against competition. Common standards and principles will have to be worked out at the EU level—an entirely new challenge.

### *China*

China has until 2014 been a net recipient of FDI. After joining the WTO in 2001, it rapidly became the world's second biggest market for inward FDI after the USA. Manufacturing companies from all over the world, led by investors from Japan, Taiwan, and Korea, rushed to build up capacity in the workshop of the world. China's inward FDI stock rose from US$ 193 billion in the year 2000 to US$ 1.09 trillion in 2014.[19]

This large FDI inflow, averaging over US$ 76 billion a year in the first decade of the century,[20] and its importance for China's economic growth and development, should not be taken to mean that China is wide open to inward FDI. China has welcomed large inflows of certain kinds of investment, mainly in manufacturing, but it remains relatively protectionist, banning FDI in many sectors and setting restrictive conditions for it in others. In 2014, China was rated by far the most restrictive of 59 major economies, including all OECD and G20 members.[21]

Meanwhile, one-way investment into China has become a thing of the past. FDI inflows have grown less quickly since the post-2008 recession and have flattened out at a level of around US$ 120 billion per annum since 2011. The rising cost of labour and other resources in China are reducing its attractiveness as a manufacturing base for export to international markets. The recession in the USA and Europe reduced the wish for risk-taking, and Western companies based in China consider that regulatory constraints on FDI have increased.

China's outward FDI has increased rapidly as its economic growth has gathered pace, moving by degrees from a stock of about US$ 4 billion in 1990 to US$ 28 billion in 2000 but accelerating rapidly since then, reaching US$ 729 billion in 2014. Most of China's initial investments targeted natural resources, whether raw materials (metals, wood, building materials) or energy (oil and coal), and were concentrated in developing or emerging economies in Asia, Latin America, and Africa. From the mid-2000s, rising commodity prices, largely provoked by insatiable Chinese demand during its fastest period of economic growth, acted as a spur to major Chinese companies to invest in extractive industries. More recent investment has diversified into a variety of manufacturing and service sectors in developed economies. Annual outflows increased over 100-fold, from US$ 0.9 billion worldwide in the year 2000 to USD$ 116 billion in 2014. In 2014, China became the world's second biggest capital exporter after the USA, ahead of Japan and Germany.[22]

China's investment in developed countries now represents about one-third of its total FDI stock but a much higher proportion of its recent annual outflows (about 60 % in 2015), driven not only by the wish to service export markets but also the acquisition of technologies, skills, and marketing assets. It is a strategic element in China's progress towards becoming a moderately wealthy society.

## The EU–China Investment Relationship

Two-way EU–China investment flows have followed the global trend, growing quickly in the past 15 years. However, while China's FDI stock in the EU has increased fivefold in the past six years and is continuing to grow steadily, flows of EU investment into China have fluctuated and they declined sharply in 2012 and 2014.[23] The value of two-way EU–China investment flows remains relatively small, well below what might be expected between such large economies. In 2013 and 2014, it was just over €20 billion a year; by comparison, EU–US investment flows in 2014, an atypically low year, amounted to US$ 180 billion a year.[24]

### *EU Investment in China*

European investment grew steadily after the Deng-inspired liberalisation in the 1990s, when China climbed from insignificance to figure among the top 20 destinations of EU outward FDI by the year 2000. It has grown even faster since, reaching a total stock of about US$ 130 billion by 2013.[25] However, China is only the tenth most important destination of EU direct investment, coming after much smaller economies, such as Singapore, Switzerland, or Hong Kong, for example. Its importance for European investment is severely limited by Chinese regulations.

Chinese rules on inward FDI are laid down in the Catalogue of Industries for Guiding Foreign Investment (or Catalogue) published by the Chinese MOFCOM, although the National Development and Reform Commission (NDRC), the planning ministry of China, is responsible for their content. The Catalogue lists sectors in which foreign investment is "encouraged," "restricted" (i.e., permitted subject to certain conditions), or "prohibited." Examples of "encouraged" sectors are manufacturing in sectors not subject to government planning and retail distribution, industries that generate domestic research and development (R&D), industries that reflect China's comparative advantage and increase

employment opportunities, and technology-intensive sectors. Permitted but "restricted" sectors include manufacturing sectors subject to government planning, such as information technology or motor vehicles. Foreign investment in encouraged and restricted sectors is subject to bureaucratic procedures that are judged to be relatively untransparent. For example, the rules of the Catalogue may be overridden by detailed rules for particular sectors, and the NDRC has to issue a permit for all applications, including those for encouraged sectors. Sectors that are prohibited to foreign investors include electricity distribution, telecommunications, legal services, most financial services, the media, and transport services.[26]

The right to invest in a restricted sector is accompanied by conditions that reduce the freedom of choice of foreign investors and, consequently, the attractiveness of the investment. These include:

- restrictions on ownership: full foreign ownership is the norm for the "encouraged" sectors, but in "restricted" sectors, foreign ownership is limited to 49 %;
- requirements for the transfer to Chinese investment partners of technology as part of the process of approval;
- where a joint venture with a Chinese company is required, identification of the Chinese partner by the government rather than the foreign investor;
- in restricted sectors, the requirement for approval of changes in products or production capacity (car or chemical plants, for example, are restricted in number and additional capacity has to be negotiated with the central government; foreign companies may also be prevented from producing products which would compete with domestic production).[27]

To sum up, Chinese regulation of foreign investment conveys the message that whilst inward FDI is welcome in some areas, investor choice is never free, even when the investment is "encouraged." The Chinese approach also implies that every step towards market opening requires a decision to amend a positive list of what is permitted. China is being pressed by both the USA and the EU to adopt the more flexible approach, widely followed elsewhere, based on a (shorter) negative list of prohibited sectors and a less bureaucratic procedure for permitted investments, such as simple registration without any requirement for approval.

EU investment in China is dominated by larger international companies (especially in the chemicals, pharmaceuticals, motor vehicle, aircraft, and food sectors), although many more mid-caps and even small and medium-sized enterprises (SMEs) are also seeking investment partnerships in China. One thousand eight hundred European companies are members of the European Chamber of Commerce in China based in Beijing, and thousands more belong to the Member State Chambers, based not only in Beijing but in many major cities across China.

The luxury car sector provides a striking example of how European trade with China has evolved into investment links. This is a sector where European products are internationally competitive and where a prosperous Chinese middle class has made the Chinese car market the biggest in the world, with sales of approximately 18 million vehicles a year.[28] Several European carmakers now have multiple automobile plants in China.

Volkswagen, for example, began to export to China in significant quantities from the 1970s. But cars exported from Europe not only took a long time to reach China, they were subject to a 25 % tariff. As early as 1984, Volkswagen had set up its first joint venture for car production in China with Shanghai Automotive Industry Corporation. It now has 18 car and component plants across China.[29] Implementation of this strategy, however, highlighted the constraints facing competitive foreign investors. First, the choice of a Chinese business partner (car companies were denied full ownership of their investments) was made in negotiations with the government. As demand expanded, the question of further plants also became a matter for discussion with the Chinese government. The frontier between the luxury car market and the mass market, and the determination of products to be produced by the joint ventures with foreign companies, was also a matter taken out of the companies' hands. In relation to IPR, too, there were difficult discussions over the kind of technology to be transferred from the European partner to joint venture companies in China.

Despite difficulties and constraints along the way, the strategic importance of these investments has been striking. Volkswagen now produces 2.8 million vehicles a year in China, Mercedes produces 240,000 in two plants, BMW 130,000 in two. The companies attribute significant shares of their global profits to the Chinese market. Some observers have commented that the German motor industry is as dependent on sales in China as sales in Germany. A fourth originally European make, Jaguar Land Rover, largely based in the UK but owned by Tata of India, announced

in October 2014 that it, too, would produce 130,000 cars in China from 2015, to avoid a high tariff, to be closer to customer needs, and to be in a position to adapt production to local consumer tastes. Meanwhile, another European car brand, Volvo, is now rapidly expanding its car production in China after being taken over by China's Geely in 2012. Although its production in Sweden still provides 16,000 jobs there, its output in China was expected to be 500,000 vehicles in 2015.[30]

Chinese economic reform is beginning to affect investment policy, but slowly. The Third Plenum conclusions held out the prospect, in principle, of restrictions on inward investment into China becoming the exception rather than the rule, and the adoption of a "negative list" approach. A year later, in December 2014, a number of changes to the current regulations were announced as the basis for public consultation. A revised Catalogue for FDI, aiming at facilitating foreign investment specifically in the secondary and tertiary sectors, came into effect in April 2015. The number of restricted sectors has fallen from 79 to 35: Sectors such as beverage manufacturing, electrical machinery and equipment, real estate transactions, steelmaking, oil refining, and papermaking have been liberalised. A registration-only procedure for "encouraged" sectors has also been announced.

These changes, however, only affected the partly open sectors of the Chinese economy. Prohibited sectors have been unaffected, and the number of restricted sectors (at 35) is still impressive. More substantial progress may be impeded by a reluctance to allow competition from foreign investors to weaken the position of SOEs, whose role in the Chinese economy was consolidated in the 2013 Third Plenum conclusions:

> We must unwaveringly consolidate and develop the public economy, persist in the dominant position of the public ownership, give full rein to the guiding function of the State-owned economy, incessantly strengthen the vitality, control power and influence of the State-owned economy.[31]

This language suggests that, at best, the Party still has to agree on the extent to which SOEs will be exposed to foreign competition, and that achieving an open economy in the sense that that term is understood in the West will take years to achieve, if it is achieved at all. The fact that SOEs dominate the services sectors in China that are of the greatest interest to the EU, such as banking, energy, transport, telecommunications, and health, is not promising.

Regulatory constraints are not the only discouragement to inward FDI in China. In October 2014, the EU Chamber of Commerce in China highlighted other problems affecting the business environment and which can be summarised as uncertainty about the rule of law in China.[32] They include:

- the uncertainty of intellectual property protection, which makes foreign companies reluctant to deploy their most valuable intellectual property in China;
- discriminatory treatment of non-Chinese companies in the enforcement of regulations by public authorities (whether in respect of product safety, environmental standards, taxation, competition, or access to finance), which adds significantly to foreign-owned companies' costs and reduces their competitiveness;
- unpredictable and non-transparent rulemaking, which creates uncertainty about future profitability (property rights relating to an investment, for example, may be put into question when land originally granted to an investor for industrial use is reallocated to housing, at short notice and without compensation)[33];
- lack of confidence in the rule of law in the event of disputes, arising from political control of Chinese courts;
- the prevalence of corruption, which involves significant additional costs in bribes, may also be a major risk to the reputation of the foreign company.[34]

None of these problems is specific to China, although uncertainty about the rule of law may be more widespread than in other emerging economies. What is of most concern in China is the accumulation of discouragements. Taken together with the still-to-be-delivered reform of regulatory restriction applying to inward investment, they amount to a substantial barrier to further growth of inward FDI from Europe. The Fourth Plenum of the CCP undertook in November 2014 to improve the rule of law in a number of respects that might be relevant to business activity, such as the reduction of corruption and capital ownership rights, but progress in this area has been slow.

Up to now, the size and the rate of growth of the Chinese market may have tended to outweigh these discouragements in the minds of European businessmen. Most internationally competitive European companies have considered that it is in their interest to secure a permanent base in the Chinese economy, even if they have been cautious about how much of their technology they make available there.

Adverse economic or political developments in China could, however, change this perception. The sharp fall in Chinese stock markets in July 2015 and January 2016 and the draconian measures taken by the government to control securities trading that followed, together with an unexpected devaluation of the RMB in August 2015, were a reminder that the Chinese economy is prone to instability and unpredictable government intervention. The slowdown in China's rate of economic growth, from a high of 14.2 % in 2007 to less than 7 % in 2015, has reduced its attractiveness as a market. There are also questions about the reliability of Chinese official statistics on growth; indicators of real activity in the economy, such as consumption of electricity or steel, which have sometimes been referred to as the "Li Keqiang index," suggest a much more modest rate of economic growth.[35] Additional shocks, such as a collapse in property prices or a more extensive credit crisis, could be expected in an economy with debt levels approaching 250 % of GDP. This more sombre economic background may convince more foreign investors that the constraints, costs, and risks of investment in China outweigh the benefits. The fluctuation in EU FDI into China in recent years may only be a statistical blip; it may, on the other hand, signal a turning point.[36]

### *Chinese Investment in the EU*

Chinese direct investment in the EU was virtually non-existent before the year 2000, but after a modest start of less than one billion euro a year during most of the following decade, it is now rising quickly. China's FDI stock in the EU quadrupled between 2010 and 2014, from €10 billion to €46 billion. The annual investment flow, still modest compared to Chinese investment in Asia, Africa, or South America, is catching up with that of EU direct investment towards China. In 2014, when new EU outward FDI to China dipped to €9 billion, new Chinese investment in the EU (at €12 billion) surpassed it for the first time.[37]

There have been a number of recent studies of Chinese direct investment in Europe. Knoerich (2012) investigates the key drivers of investment by Chinese companies,[38] Clegg and Voss (2013) look at EU Member States' national policies to attract Chinese investment,[39] and Nicolas (2014) provides a comprehensive survey of Chinese company behaviour and of the restrictions on FDI within the Member States.[40] Backaler (2014) also gives an interesting typology of the motives for Chinese firms' FDI across the globe, giving some European examples.[41]

What kind of Chinese companies are investing in Europe, and why? In terms of number of companies, most Chinese investment in the EU has come from mid-caps and smaller companies, which make relatively small-scale investments in representative offices and distribution services. Their driving motive has been to consolidate their export market; this was the main reason given for investment in Europe by respondents to the European Union Chamber of Commerce in China (EUCCC) 2013 survey of 74 Chinese firms investing in the EU.[42] In terms of size of investment, however, it is the larger Chinese companies, including SOEs, that are responsible for four-fifths of the total value of Chinese investment.[43]

Some of the biggest Chinese investments have been in the energy sector, in public utilities, and in infrastructure projects, where large Chinese companies or sovereign wealth funds have acquired shareholdings in major European companies, including oil majors, electricity generators and distributors, and ports and airports. Similar investments have also taken place in the financial services sector, especially in companies based in the City of London.

Other acquisitions, usually involving full ownership, have been motivated by Chinese manufacturing or service companies wishing to strengthen their technology, market, and skills base (Geely bought Volvo for US$ 1.6 billion in 2010, Bright Foods bought Weetabix for US$ 1 billion in 2012, and Baugur Group bought House of Fraser for US$ 5 billion in 2006). Chinese companies are also investing in or taking over control of specialist European firms in order to acquire technology and expertise: Examples include Sany's takeover of Putzmeister, a specialist German cement-pump producer, for US$ 390 million in 2011, and COFCO Wine and Spirits' decision to purchase Chateau de Viaud, a Bordeaux vineyard, in 2011.[44]

Major Chinese multinational companies such as Huawei and Haier, already internationally competitive in the telecommunications and electrical goods sectors, have made large greenfield investments in both production and research facilities in Europe. Most Chinese investment has been concentrated so in the biggest Member States, which suggests that size of the national market and level of technology or specialist skills is an important consideration. The UK has been the single biggest destination, arising from investments in the energy, real estate, and financial sectors, followed by France (also important for energy) and Germany (engineering specialisation).

Investment in Eastern and Southern Member States is now growing, however. Much of this investment, such as COSCO's 30-year lease on the cargo terminal in Piraeus harbour and investments by Chinese SOEs

in motorway and high-speed rail development in South-East Europe, is directly related to the "One Belt, One Road" initiative, also referred to as the New Silk Road, announced by President Xi in November 2013. This strategic initiative has both economic and political aims. It is intended to generate more effective communications and transport systems between China, Central Asia, and Europe and thereby promote closer economic cooperation across this vast region, whilst at the same time promoting economic development in the less favoured Western provinces of China.[45] The One Belt, One Road initiative is also intended to reinforce China's political presence in an area traditionally regarded as a Russian sphere of influence. China has committed to a US$ 40 billion programme of foreign investment to support the initiative, which will be co-funded by participating countries.

This expansion and acceleration of Chinese investment in the EU should, however, be kept in perspective. China is still not among the top ten sources of FDI in the EU and accounted for less than 1 % of its inward FDI in 2013.[46] Whilst Chinese companies' interest in European technology and skills may lead them to invest more heavily in Europe in future, their level of investment is unlikely to rise to a completely different order of magnitude. The need to access scarce energy and natural resources in other parts of the world remains a priority.

Although the EU, founded on the principle of free capital movement, is much more open to inward FDI than China, there are constraints on Chinese investment in Europe owing to the diversity of Member State rules on inward FDI. Whilst in future the EU intends to conclude investment agreements with its international partners, in which common EU rules on the right to invest will be defined, for the time being the situation is not clear-cut. Member State attitudes to inward FDI vary. Eleven have procedures for vetting foreign investment, five of them revised or introduced since 2007.[47] The exclusion of the defence sector, telecommunications, transport, or education because of national security concerns is common. Some Member States have also chosen to identify other sectors as strategic or economically sensitive. France requires that any investment in the food sector should be notified to the authorities and assessed; Germany and Austria do the same for any investment exceeding 25 % of ownership in public utilities. Other Member States, such as the UK, rely on general provisions that allow the government to review any foreign investment that is not in the national interest or hold golden shares that allow them to oppose any investment.[48]

Despite these differences, there is a consensus within the EU that direct investment from China should be treated like any other foreign investment. Apart from the French government's strenuous and successful efforts to find an alternative bidder to Bright Food for Yogplait, a yoghurt manufacturer, in 2010,[49] there have been no publicised cases of Member State intervention to restrict Chinese investment. The reservations about FDI from China that is found among opinion leaders in the USA appear to be largely absent in Europe (although even in the USA, there have been only three rejections of Chinese investment projects in the past 25 years). It is, however, possible that some proposed Chinese investments in Europe have been discreetly abandoned once a host country has made its opposition known. The fact that most of the Chinese investment in Europe has taken place during an economic downturn, when investment from any source was in short supply, may also have influenced national policy.

Some have asked whether the EU should establish a system for vetting inward FDI similar to that of the USA. The existence of a single market within the EU implies that decisions on inward FDI taken by one Member State may affect others. In 2011, two European Commissioners proposed a Commission study of a mutual information system that would allow all Member States to consider proposed inward FDI in any Member State, but they did not obtain support in the Commission.[50] The position of the EU as a whole towards inward FDI remained open. The negotiation of a bilateral EU–China investment agreement, however, provides the biggest test yet of that position.

## Prospects for Change: An EU–China Investment Agreement

When the EU and China opened negotiations for a BIT in late 2013[51], it had already taken two years to agree on the scope of the negotiations. China had originally wanted to restrict the agreement to investment protection (the rules governing ownership of foreign investments, the right to compensation in the event of expropriation, and the procedures for applying these rules). The EU had to press hard for the negotiations to include rules regarding access for foreign investment, which would provide the main added-value of an EU–China agreement compared to existing bilateral agreements at national level.

This disagreement about objectives was an early pointer to difficulties. Inclusion of rules of access for investment in the BIT will present a major challenge for China, although the EU will also have to address unresolved questions about its own policy.

If China is to reach agreement with the EU on access to investment, it will have to reconsider its policy of protecting the leading position of SOEs in the Chinese economy, one of the recurring principles of the Third Plenum conclusions on economic reform. SOEs dominate the economic sectors that would be of greatest interest to the EU in the investment agreement negotiations: health, telecommunications, other public utilities, and financial services. It will be difficult for the Party to liberalise investment substantially or quickly in any of these sectors without drawing attention to the contradiction between two of the guiding principles of the Plenum conclusions: the determinant role of the market, on the one hand, and the leadership and controlling power of the state-owned sector, on the other. Undermining the position of SOEs will weaken government finances as well as political control of the economy.

The negotiations will also require the EU to put flesh on the bones of its theoretical common approach towards inward FDI. FDI is an area in which competition between Member States to attract investment is rife (most Member States have active foreign investment promotion services) and, as already noted, where differences between them in defining strategic interests to be protected against foreign investment are marked. There is little appetite to establish a fully fledged EU policy in the form of, say, a common assessment procedure for proposed foreign investments, but there are questions in the minds of Commission lawyers as to whether different national systems for the control of foreign investment are compatible with the single EU market for goods and services and with the EU's new international competence for investment negotiations.[52]

China's economic weight and new activism as an outward investor is forcing the EU to think harder about these issues. Apart from the rapidly increasing Chinese investments in most Member States, China's One Belt, One Road initiative, which aims to renovate and reinforce transport and communication links between China and the regions to the west of it and build up the economies of central Asia, also has implications for Europe. China has created a special fund of €10 billion for infrastructure investments within Eastern and South-Eastern Europe, and a number of investments in motorways, high-speed rail links, and harbours in

South-East Europe have taken place. [53] China has also discussed with the EU how it can participate in projects financed by the new €300 billion European Fund for Structural Investment and proposed in September 2015 that the European Bank for Reconstruction and Development include a Chinese board member.

Eleven negotiating rounds for a BIT have been held so far to define the scope of negotiations but the time of writing there is no draft agreement text on the table. This is hardly encouraging, notwithstanding the Chinese Ambassador to the EU's claims in June 2015 that both sides "agree to accelerate the negotiations so as to achieve substantial progress by the end of this year. During the 17th China–EU Summit (i.e., during 2016), Premier Li Keqiang will exchange views with his European counterparts on this important topic and provide political guidance for future work."[54] Off the record, EU negotiators estimate that the process could take a decade, even if there may be pressure to deliver "interim results" within a shorter deadline.[55]

Similar negotiations between the USA and China have been underway since 2008.[56] EU–China investment negotiations could perhaps move faster than the US–China ones, if only because the EU has made clear that any future negotiation of a bilateral FTA between the EU and China, which is now a major goal of Chinese economic diplomacy, depends on the conclusion of the BIT. As the EU has already negotiated or is negotiating FTAs with several of China's neighbours, as well as the TTIP with the USA, China may be ready to make some concessions on investment in order to bring forward negotiation of an FTA with its second biggest export market.

The decision of Chinese leadership on this issue will, however, be based on domestic considerations rather than the benefits for China of easier trade with the EU. The main benefit of allowing FDI into China in sectors where it is today excluded would be the promotion of a more internationally competitive economy through the introduction of new technologies, skills, and management practices. The Chinese leadership appears to recognise that more inward FDI is a necessary part of Chinese economic reform.[57] But that somewhat theoretical argument may not overcome resistance to change from important vested interests in China, such as the SOEs that dominate the sectors where inward investment is restricted or excluded, and the broader fear of pressure for political change that could

result from further economic liberalisation. The modest amendments to China's regulations governing inward FDI announced in April 2015 suggest that the Chinese approach will be cautious, with incremental changes being accompanied by long transition periods.

In these circumstances, early delivery of an EU–China BIT that would substantially reduce barriers to EU direct investment in China and make a significant difference to EU–China economic relations seems highly unlikely. EU negotiators recognise that selective and gradual market opening, on a case-by-case and sectorial basis, and only when that suits China, seems to be a more realistic outcome.[58] The authorities on both sides, however, have raised expectations about the BIT, by making it the highest economic priority of the 2020 Strategic Agenda for Cooperation agreed at the 2013 Summit.[59] Failure to deliver substantial improvements for European direct investment in China, at a time when Chinese investment in the EU is rapidly increasing, will be seen by European business interests as yet another indicator of the one-sidedness of the EU's economic relationship with China. The EU's trade deficit with China is already well known; an EU–China investment deficit may be in the making.

Conclusion

The promotion of further investment links between the EU and China appears to be a priority for both sides, the opening of a new chapter in EU–China economic relations. Yet the slow pace of negotiations for a BIT reflects the underlying political difficulties in reaching an agreement that will guarantee greater symmetry of access for direct investment.

For China, the prospect of EU investment in areas of the Chinese economy where SOEs dominate the market, as well as further relaxation of Chinese constraints on inward investment in other areas, raises problems of substance as well as presentation. Even the political link made by the EU between a successful outcome to these negotiations and the opening of negotiations for an EU–China FTA may not be enough to persuade the Chinese side to make the kind of concessions that the EU wants.

For the EU, whilst Chinese investment in Europe is generally welcome as a means of accelerating infrastructure spending and economic recovery, it will be difficult to justify a BIT that fails to demonstrate the value-added of EU-level negotiations with China. Unless China can offer substantial market opening, albeit implemented over a transitional period, it is unlikely that the EU will want to accept a deal.

## Notes

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of Chinese FDI in the EU in 2013, whereas its economy contributed only one per cent of EU GDP.

EU statistics (from Eurostat) also have shortcomings. Luxembourg, although an important destination of investment from China into the EU, has not until recently submitted foreign direct investment statistics to Eurostat, on the grounds of protecting banking confidentiality. Several Member States are regularly late with their submissions.

Alternative independent sources, based on the tracking of mergers and acquisitions by individual companies or announcements of greenfield investments, such as those produced by The Rhodium Group, give a more up-to-date picture of the location and source of bigger investments. However, they do not include much of the investment by smaller companies that appears in official statistics.

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CHAPTER 6

# Innovation and Research

*Key questions:*

- *What are the areas in which closer cooperation between the EU and China might be beneficial, and why?*
- *What political obstacles stand in the way of such cooperation, and are they likely to be overcome?*
- *Is the "mixed" EU competence for innovation and research a handicap in dealing with China?*

China and the EU are both economies in transition, restructuring and investing heavily in the knowledge and innovation needed to make them more productive, knowledge-intensive, and sustainable. On the surface, they have many common interests and compatible talents which would argue for closer cooperation between them, but, as this chapter will show, they are not as well matched as might appear at first sight, and there are persistent obstacles to such cooperation. This chapter aims to analyse each side's capabilities and attitudes towards cooperation in research and innovation.

China is already an important research partner for the EU, considered to be the third most significant participant in external cooperation programmes, after the USA and the Russian Federation.[1] This partnership has been developed through formal agreements, policy dialogues, and project collaboration since first bilateral links under the 1998 EU–China Scientific and Technical Cooperation Agreement. Both economies recognise the importance of improving their research outputs and

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investing in innovation-led technology as key factors in maintaining future industrial competitiveness. In this context, the EU has long recognised the contribution that international participation in the European Research Area (ERA) can bring as a way of enhancing competences through cooperative research beyond the borders of any one Member State. Chinese visibility in collaborative projects with the EU is noticeable in sectors that converge with its own strategic research objectives, such as agriculture, biotechnology, urbanisation and clean energy sectors.[2]

Whilst the Chinese have clear intentions to compete at the very highest level, their performance to date has been mixed. High levels of funding and the large number of human resources mobilised in R&D sectors are necessary but insufficient conditions for China to achieve an economic transformation. China's significant advance in international comparisons of R&D intensity (gross expenditure on R&D as a percentage of GDP), where its ranking has steadily risen over the last decade, has provided some commentators with headlines that describe the inevitability of Chinese dominance, but this chapter argues that the reality is much more nuanced.[3] China has enjoyed competitive success in areas of incremental innovation in manufacturing and logistics markets, but is relatively weak compared to advanced economies in basic research, managing knowledge flows, and sustaining the commercialisation of ground-breaking ideas—what might be termed disruptive innovation[4]—when brought to the market, all of which could combine well with the Europe's greater capacities in these areas. For example, according to assessments by the OECD in 2015, the EU and the USA dominated invention patenting for recently discovered disruptive technologies within quantum computing and health-related technology sectors when compared to China, although the Chinese have gained some ground since 2007.[5]

This chapter will examine these contrasting yet complementary abilities in China and the EU, exploring areas of synergy and collaboration that have been prioritised by both sides. Whilst recognising achievements at the level of some individual projects, such progress will be assessed against the apparent failure to realise more extensive structural cooperation because continuing political obstacles on both the European and Chinese sides and a lack of mutual trust are preventing deeper bilateral engagement.[6]

For the EU, policy fragmentation remains a problem, as research and innovation policy struggles for pan-European coherence as a mixed competence. Member States often operate with zero-sum mentalities regarding engagement with China, whilst at the same time, the Commission's

DGs seek EU-level agreement on broad cooperation priorities. For China, policy shortcomings continue to blight incentives for international cooperation, such as weaknesses in intellectual property protection enforcement, opaqueness in the legal protection of trade secrets (especially significant for innovation-driven enterprises), continuing preferential Chinese government procurement in favour of domestic Chinese firms, and compulsory technology transfer in a number of knowledge-driven investment sectors.[7]

## The Policy Framework for EU–China Cooperation

### *Collaborative Policy Initiatives*

The EU's overarching technology strategy is based on promoting the principles of *open* innovation in contrast to other, more traditional types of *closed* approaches. Open innovation implies that research and innovation success is no longer achievable within the confines of a single organisation, research group, policy body, or country but instead needs to be fostered between enterprises and institutions at an international level. It depends on creating what is effectively a distributive model for the nurturing, creation, and practical application of new ideas, in which "purposive inflows and outflows of knowledge" cross company and national boundaries.[8] Within the EU, the principles behind these goals are jointly managed by the European Commission and the Open Innovation Strategy and Policy Group (OISPG), which feeds strategic thinking into EU policy formation. One of the important aims of OISPG is to allow the EU to exploit and sustain its innovative advantage in knowledge-rich sectors where policy fragmentation, coupled to a lack of coordination, has arguably been weakening its capabilities. This objective has become more important as emerging economies such as China seek to move up the production value-chain.[9]

EU research cooperation with China is based on the 1998 Scientific and Technical Cooperation Agreement, under joint responsibility of the European Commission's DG Research and Innovation (DG RTD) in Brussels and China's Ministry of Science and Technology (MOST) in Beijing. This agreement has enjoyed heightened visibility at Summit level in recent years because of the importance attached to innovation by both sides, with political support helping to spur the creation of a Science and Technology Partnership (STP) in 2009 to promote common priority areas, followed by an administrative arrangement in 2010 that enabled each side

to accelerate research projects in areas of common interest.[10] However, the Partnership's principles were built on a rather low base point of collaboration—for example, one analysis argued that in the decade before 2009, there were "almost no cases where EU participants were involved in Chinese funding programmes."[11]

Chinese participation within the EU's last Research Framework Programme (FP7), which ran until the end of 2013, was intended to reinforce progress and included a range of technical areas, the top three sectors being healthcare (19 % of the total), environment (16 %), and ICT (12 %). Activities covered 274 collaborative research projects and included a total contribution from the EU of €35.2 million.[12] FP7's rationale was to focus on facilitating research outcomes, in contrast to many other foreign sources of funding for the Chinese that typically prioritised capacity-building, reflecting the fact that China's research infrastructure had already received significant domestic stimulus. This emphasis may explain the high level of involvement of Chinese participants under the Programme. Moreover, nearly three-quarters of the Chinese participants in EU framework programme projects were *new* partner entities, indicating a rising trend in fostering productive networking as part of a broader trust-building process. This kind of engagement by the EU is seen from the Chinese perspective as markedly different to that of the USA, whose concerns about the security aspects of innovative research and development work inhibit collaboration and mutual investment even in the context of purely commercial endeavours.[13]

One example of two-way teamwork with Europe has been the OpenChina-ICT project, giving researchers on both sides tools to create collaborative ventures in information and communications technology. Led by the German research provider Fraunhofer in partnership with both European and Chinese organisations, this initiative concluded in December 2013 with a plan for future action to enhance bilateral communications, improve researcher and student exchanges, and provide better research support for industry in both economies.[14] In order to counter claims that such initiatives often offer little more than laudatory objectives without tangible results, the CHOICE project established in January 2014 as a two-year follow-on from the OpenChina initiative argues that it has delivered concrete collaboration agreements in high-value sectors of priority interest to both European and Chinese enterprises, such as in the design of multimodal software systems for the medical services sector.[15]

China is seen as a key target for further cooperation under the Horizon 2020 programme, which has replaced the former Framework Programme. Whilst EU research and innovation funding is no longer automatic for the

BRIC economies, Chinese involvement is expected to continue at a relatively high level due to the fact that much of Chinese R&D is already well-funded. In the view of one senior Commission official, these budgetary changes are not intended to exclude prospective partners; they merely recognise the new economic strength of many emerging countries, including China. FP7-funded projects such as Dragon Star will also continue to offer practical help to Chinese organisations and individuals wishing to participate in Horizon 2020 initiatives whilst enabling European researchers and enterprises to engage more actively in collaboration. Chinese partners can bring both specialised expertise and access to local data and field research beyond Europe, for example, in niche areas such as biomaterials.[16] Small-scale but useful initiatives to realise this potential include online calls to increase Chinese participation in peer reviews of project assessments and a Travel Grant Scheme to enable European specialists to identify a potential Chinese partner first-hand through participation in events such as the Technology Cooperation Fair in Chengdu.[17]

Similar initiatives have been evolving in the context of fostering closer bilateral cooperation in innovation. In 2012, the two sides announced the formation of the EU–China Innovation Cooperation Dialogue (ICD) which held its first meeting in November 2013 in Beijing.[18] The ICD builds on the principle that the economies of both China and the EU each need to sustain future competitiveness through promoting increased levels of innovation and that this can be achieved only by nurturing success on the foundations of an effective research and development platform. In this objective, prioritising knowledge creation is of vital concern to both sides.[19]

### *Cooperating on Common Concerns*

Common concerns in research, development, and innovation overlap not only in domestic sectors such as food security and biotechnology but also in others that address emerging global challenges, such as sustainability in urbanisation, energy efficiency, and environmental protection. These priorities help to explain the cooperation projects that have dominated the first years of the Horizon 2020 strategy. Three examples drawn from across this spectrum stand out in particular:

(a) *Food, agriculture, and biotechnology*

The European Commission has agreed on a Letter of Intent with the Chinese Academy of Agricultural Sciences in order to promote research

cooperation in specific areas such as inland water research, bio-economy, and food security.[20] Coupled to these primary areas of concern are themes such as crop development, animal welfare policy, and livestock breeding systems. Each represents an issue of political and public concern in both economies, but there continue to be significant challenges in managing differences in policy and technical understanding.

For example, in animal welfare, recent research has shown that a number of problems in China may stem from mismatches between genetic and environmental conditions, leading to some breeds enduring sub-optimal rearing. Jointly developed solutions will take time to emerge and embed and will to take account of both international scientific best practice and local cultural sensitivities.[21]

(b) *Sustainable urbanisation*

The idea of linking economic development with sustainable urbanisation is a broad policy objective for the EU that includes a number of different research topics within the Horizon 2020 framework. One of these is the Smart Cities programme.[22] What is being proposed here is active Commission participation with involvement of experts from both Member States and China with the intention to move beyond hosting joint workshops to achieving practical project outcomes on the ground.[23]

An initial scoping project—called UrbaChina—was successfully completed in 2015 after a four-year effort to pinpoint key problem issues and target priority urban areas. The outcomes from this phase were four principal themes to take forward: patterns of urbanisation in China caused by shifts towards a services-led economy, territorial expansion pathways for Chinese urban housing, the provision of transport infrastructure and social welfare to support expansion trends, and the development of planning cycles to deliver public spaces and sustainable urban communities. These were anchored on specific case studies from Shanghai, Chongqing, Kunming, and Huangshan, which were together seen as cities that captured the breadth of different conditions of China's contemporary urbanisation challenges.[24]

(c) *Advanced telecommunications network infrastructure*

China's achievement in ICT is now recognised as having moved beyond an assembly hub role, although technological leadership at an internationally competitive level is limited to a small number of major firms, such as ZTE and Huawei.

The role that individual companies play in fostering closer bilateral relations and in building trust has been noted at the political level. For example, in a speech to European businesses in early 2014, Yang Yanyi, China's ambassador to the EU, made clear that, in Chinese eyes, Huawei "plays an important role in the development of China–EU relations" through its procurement spend of nearly €3 billion in Europe during 2013.[25] The EU has also recognised that Chinese research on network technologies and human-computer interactions for the next generation of internet technologies is valuable for both sides and that the EU could greatly benefit from effective cooperation with Chinese laboratories in this field.[26]

The next steps for these flagship initiatives will be to target specific research projects for funding to take forward each theme.

Despite positive progress in these areas, there remain two important considerations. First, how will the success of these projects actually be measured, at least from a European perspective? Second, will such measurements be able to reliably show whether the EU–China cooperation dialogue has been effective in facilitating success? European Commission officials acknowledge that both questions will need to be addressed, but for now, the message is that future evaluation will also need to take into account *political* as well as business criteria for success.[27] For example, one interviewee questioned during research for this book did admit that the—albeit still quite new—ICD with the Chinese had thus far been largely "empty of substance," but that it did offer a platform to bring together high-level Chinese and European decision-makers to publicly reaffirm their intentions.[28]

In order to achieve its political objectives with China in this policy area, the EU is dependent on securing reliable partnerships built on complementarities with potential Chinese firms. This can still be problematic despite progress with specific projects. China's research and innovation strategy, notwithstanding repeated declarations from the Chinese side in favour of deepening collaboration, has been strongly criticised for focusing more on developing national innovation capacity to achieve technology leadership than on fostering genuine collaboration to achieve international breakthroughs. Whilst such a nationalist edge to R&D policy may be understandable from a re-emerging economic power seeking to leapfrog rivals, it is widely acknowledged that such narrow scoping of scientific support is at best detrimental and at worst obstructive to achieving China's policy goals.[29]

However, there are signs that some headway is being made in this respect. In late 2015, the European Commission highlighted "substantial

progress" made on the development of reciprocal access to funds under the EU–China Co-Funding Mechanism which can act as a spur to consolidating bilateral cooperation.[30] The announcement that MOST had agreed to provide an annual allocation of RMB200 million to support China-based entities "participating in joint projects with European partners under Horizon 2020" has been seen as highly significant. To the extent that in future this develops into encouragement of the participation of EU partners in China's research programmes, as well as Chinese partners' participation in the EU's research programme, this could help to belief the nationalist tone of China's earlier engagement pattern and allay concerns about a lack of reciprocity on the Chinese side in implementing the principles of numerous bilateral cooperation agreements.[31] The EU, for its part, will provide €100 million each year as part of its commitment to sustaining future cooperation.[32]

A collaborative approach that could enhance China's domestic capabilities in knowledge-rich industries would certainly be in China's interests. The pursuit of increased levels of innovation and the improvement of the quality of scientific output across the Chinese economy is now a strategic priority for China, which may help to explain the more recent emphasis on enhancing cooperation with the EU.[33] Leadership in science and technology that produce high-value knowledge-intensive products for domestic and international consumption is essential for the future success of China's economic development, as it seeks to rebalance the structure of its economy to a more viable growth model, moving away from a reliance on low-wage labour arbitrage towards middle-income sustainability. Too great a dependence on overseas intellectual property in China's export-led industries has emphasised low value-added assembly on items *made in China* at the expense of moving to products that are *made by China*.[34]

## Chinese and European Innovation Capabilities in Comparative Perspective

The Chinese government has long been aware of the country's current weaknesses. In 2006, the State Council initiated a major overhaul of technology policy with a view to facilitating China's evolution into a major research and scientific power of the future. The Medium and Long-term Science and Technology Policy 2006–2020 (hereinafter S&T Policy) was the result. It outlined substantial changes that had to take place in order for China to realise its ambitions. In political terms, sustainable development

is another component of the performance legitimacy of the CCP and is therefore as essential for regime security as it is for economic prosperity.[35]

China has achieved many of the benchmarks laid down in its S&T policy but has yet to make substantive breakthroughs in disruptive, industry-shaping, outputs. Substantially increased funding for domestic research and development projects, the construction of advanced, well-equipped science parks, and the training of a growing number of commercially minded specialists were the key objectives of this plan, with a view to creating a national innovation system that could feed into strategic economic goals.[36] Nevertheless, evidence from international analyses confirms that China has not yet become a leader in knowledge-rich industries. It remains a follower, albeit one with great potential.[37] These realities help to show why cooperation with the EU has become important for China.

### *China's Investment in R&D Inputs*

China has been investing heavily in science and technology in order to promote innovation at the domestic level. This has led to impressive year-on-year increases in spending, both in absolute terms and in relation to GDP. The level of national gross expenditure on research and development (referred to as R&D intensity) shown in Fig. 6.1 illustrates that China is

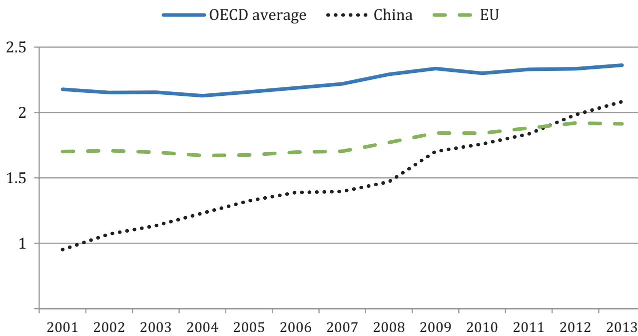


**Fig. 6.1** R&D intensity: gross expenditure on research and development (GERD) for selected economies as percentage of GDP. *Source*: Based on data from OECD Main Science and Technology Indicators (MSTI) database, July 2015. See http://www.oecd.org/science/inno/msti.htm, accessed 30 November 2015

now among the world's top spenders on research in relative terms, surpassing the EU and approaching the OECD average for 2013.

A comparison with selected national economies shows that China has now surpassed a number of leading EU Member States in its R&D intensity, including leading innovative countries such as the UK, although it is still some way from challenging the position of Germany and Finland (see Fig. 6.2). China's S&T Policy aims to reach a GERD of 2.5 % of GDP by 2020; on current estimates, this seems quite achievable.[38]

In terms of total spending, one research organisation has estimated that China will match America in gross expenditure by 2022, when both economies are expected to invest around US$600 billion on research and development as a spur to innovation.[39] China's expenditure is dominated by enterprises rather than government, although numerous public research institutes were converted to enterprises in the early years of the twenty-first century, and some of these retain strong connections with public authorities.[40] This privatisation of China's economic and human capital was designed to commit it to market-led research priorities but may also have had an adverse effect on China's capacity to develop fundamental research capacities, as many of these newly privatised institutes have concentrated on lower-level outputs that could be commercialised

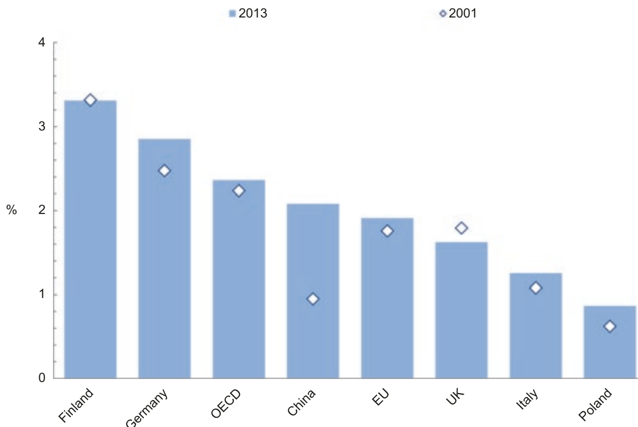


**Fig. 6.2** R&D intensity 2001–2013—Comparative trends of selected economies. *Source*: Based on data from OECD MSTI database, July 2015. See http://www.oecd.org/science/inno/msti.htm, accessed 30 November 2015

quickly.[41] This may be a further explanation of the country's current bias towards incremental innovation as opposed to blue-sky thinking.

Comparative international figures on R&D intensity should therefore not be considered in isolation. Overall, the Chinese research landscape contrasts with that of both the USA and Europe as still being "highly centralised, tightly organised and controlled by the central government in Beijing."[42] Despite decades of economic reform, many industrial sectors continue to be dominated by large SOEs with ready access to capital and political support. Under such conditions, it can often be very difficult for smaller and potentially more entrepreneurially dynamic firms to obtain finance and bring ideas to market due to the top-down decision-making hierarchies that are prevalent across China's funding bodies.[43]

### *Assessing the Quality of China's Innovative Outputs*

Innovation capabilities are usually measured against a broad range of indicators, including levels of patenting activity, the production of internationally regarded journal articles, the extent of international collaboration, and the number of research specialists as a proportion of overall employment. Care needs to be taken when evaluating the quality and value of outputs from China's significant levels of R&D expenditure.

There has been spectacular growth over recent years in Chinese patenting activity through Beijing's State Intellectual Property Office (SIPO) (see Fig. 6.3). Figures published by the WIPO show that since 2011, when SIPO first overtook the USA and Japan in terms of the number of patent applications received, China has consolidated its position as the world's leading patenting country.[44] Similar trends are observable from data analysing country of origin for these applications, with 85 % of SIPO's applicants being from Chinese residents—the highest of any office worldwide in 2013.[45]

The relatively modest showing of the European Patent Office (EPO) during these years may be explained by the absence of a European Patent (known formally as the "European Patent with Unitary Effect"). This measure was passed into law in 2013 and will create a unitary patent for the EU, but it will only come into force once ratified by 13 Member States, which must include France, Germany, and the UK. As at the end of 2015, this requirement had been only partially achieved, with eight ratifications confirmed including France but not yet Germany or the UK. The

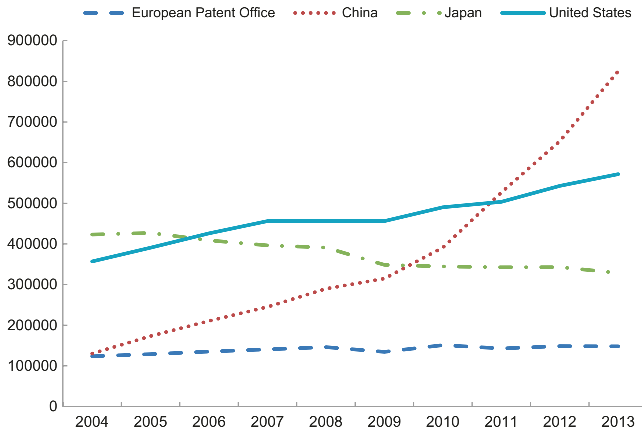


**Fig. 6.3** Growth in China's patent application filings from 2004 to 2013. *Source*: Based on data from WIPO statistics database, http://www.wipo.int/ipstats/en/statistics/patents, accessed 30 November 2015

absence of a unitary patent across the EU continues to make patenting decisions for innovating enterprises across Europe less than straightforward, particularly when compared to procedures in the USA and China.[46]

There has been much debate about the significance of China's remarkable growth in patent applications. Some analysts have pointed to political pressure from regional academies or provincial governments, as well as national agencies, to promote patent activism across China. Financial incentives have been offered to researchers who create patentable ideas, to companies that file patents, and to patent evaluation officials who grant patents.[47] These potential distortions suggest that in China not all patents may be associated with high quality. It is therefore necessary to assess Chinese innovation capabilities with a more nuanced analysis than simply numbers of patent filings. One alternative approach is to identify how many of these domestic patents have also been assessed and registered in international filing systems.

Typically, such international assessments are carried out either through treaty mechanisms such as the Patent Cooperation Treaty (PCT), managed globally by the WIPO, or through combined direct filings in the world's three major patent offices—the United States (USPTO), the EPO, and the Japan Patent Office (JPO)—which together are known as the triadic patent family. International filing of a patent is more time

consuming than that carried out locally and, for Chinese enterprises in particular, is also likely to involve greater costs and a much more rigorous assessment of the worth of an invention than the one typically expected at China's SIPO. It is reasonable to assume that only the most important invention patents from a given economy will use these filing processes and that, as a result, usage statistics are a valuable proxy for assessing the comparative technological sophistication of businesses in different economies.[48]

China as a country of origin for international PCT filings and triadic patent family filings shows a much more mixed level of performance (see Table 6.1 for PCT filings and Table 6.3 for triadic filings).

Chinese firms have, over recent years, shown a rapidly growing interest in international patent filings through the PCT, although a number of EU Member States continue to be significant participants. However, whilst China has clearly increased its use of international patent filings quantitatively, qualitative weaknesses persist compared to the country's competitors.

Data published by the WIPO in 2015 indicated that, whilst the Chinese are by far the most active middle-income economy using national phase filing facilitation of the PCT, on average, national phase entries (NPE)

**Table 6.1** Number of PCT international filings by country of origin—Top ten

| *Country of origin* | *Year* | | | | | | |
|---|---|---|---|---|---|---|---|
| | *2008* | *2009* | *2010* | *2011* | *2012* | *2013* | *2014* |
| USA | 51,668 | 45,658 | 45,090 | 49,210 | 51,859 | 57,441 | 61,492 |
| Japan | 28,763 | 29,810 | 32,216 | 38,864 | 43,523 | 43,771 | 42,459 |
| China | 6119 | 7896 | 12,300 | 16,398 | 18,620 | 21,514 | 25,539 |
| Germany | 18,857 | 16,793 | 17,559 | 18,847 | 18,750 | 17,913 | 18,008 |
| Republic of Korea | 7902 | 8040 | 9604 | 10,357 | 11,787 | 12,381 | 13,151 |
| France | 7076 | 7218 | 7231 | 7406 | 7802 | 7905 | 8319 |
| UK | 5479 | 5039 | 4892 | 4875 | 4917 | 4847 | 5282 |
| Switzerland | 4361 | 4420 | 4011 | 3511 | 4077 | 4188 | 4218 |
| Netherlands | 3778 | 3677 | 3761 | 4045 | 4222 | 4372 | 4115 |
| Sweden | 4135 | 3567 | 3303 | 3476 | 3600 | 3946 | 3925 |

*Source*: Based on data from WIPO statistics database, http://www.wipo.int/ipstats/en/statistics/patents, accessed 30 November 2015. See also PCT Yearly Review 2015 (Geneva: World Intellectual Property Organisation), pp. 36–37

n China's PCT filings list only one foreign economy, typically either the USPTO or the EPO (NPE is defined here as the offices apart from SIPO in which the patent is also intended to be filed). The same figures for the EU's most innovative Member States range from an average of 3.4 offices in German PCT filings, 3.3 in Swedish, 3.9 for the UK, to 4.3 for the Netherlands. The most popular five destination offices for leading EU users of the PCT are the USPTO, the EPO, SIPO, the JPO, and the patent office of the Republic of Korea. This implies that whilst China's international outreach is expanding, the intention of Chinese resident corporations to patent overseas may be less marked than for many European firms.[49]

China's patents filed through the PCT have also tended to be focused on a narrower range of industrial sectors and technology fields and have originated from a much smaller number of firms when compared with those from the USA, Japan, and the EU. The research data for China in 2015 showed a very heavy concentration in the field of digital communications, whilst Germany's entries were spread over areas such as electrical machinery, energy technology, medical instruments, engineering, and transport technology.[50] Having said that, China's Huawei did file the highest number of applications of all firms in 2014 and two of the top ten applicants were Chinese firms (see Table 6.2), an impressive achievement. The top 50 firms with the most prolific use of the PCT are, however, dominated by those of American, European, and Japanese origin.[51]

In terms of triadic patent filing, latest figures from the OECD show that in 2013, just over 54,000 triadic patent family applications were filed.

**Table 6.2** Triadic patent families—Number filed by selected economy by priority year[52]

| *Country/region* | *Year* | | | | | | *2013 share* |
|---|---|---|---|---|---|---|---|
| | *2008* | *2009* | *2010* | *2011* | *2012* | *2013* | |
| OECD | 48,699 | 48,029 | 47,362 | 48,945 | 49,661 | 50,604 | 93.6 % |
| Japan | 15,723 | 15,326 | 16,042 | 16,423 | 16,220 | 15,970 | 29.5 % |
| USA | 13,852 | 13,553 | 12,823 | 13,254 | 13,819 | 14,606 | 27.0 % |
| EU | 14,728 | 14,451 | 13,558 | 14,067 | 14,111 | 14,162 | 26.2 % |
| Germany | 5472 | 5560 | 5352 | 5396 | 5440 | 5465 | 10.1 % |
| China | 824 | 1295 | 1417 | 1542 | 1657 | 1785 | 3.3 % |

*Source*: Based on data from OECD Main Science and Technology Indicators: Volume 2015/1, pp. 82 and 83, updated August 2015 (OECD Publishing). See also OECD Data: Triadic patent families: doi:10.1787/6a8d10f4-en, https://data.oecd.org/rd/triadic-patent-families.htm, accessed 16 December 2015

Chinese companies gained ground over recent years compared to their international competitors, more than doubling the number of filings since 2008 (see Table 6.3). Yet, even after years of investment through the country's S&T policy, China remains well outside the top five economies in using triadic patents. This is consistent with the broader analysis of China's competitive landscape conducted annually by the World Economic Forum (WEF), in which China's standing in providing key enablers for innovation falls well short of some EU Member States.

These statistical indicators tend to give credibility to themes that are brought up in dialogue at the political level between the EU and China in respect to their future economic development. The EU, for example, has been critical of practices that may inhibit Chinese innovation as well as economic cooperation with European firms, such as the absence of reliable rule-of-law principles in domestic market regulation and a lack of access to free-flowing information portals because of China's internet controls that appear to have tightened in recent years. Achieving successful collaboration with EU partners is important for China but so is an effective institutional and legal environment in which such collaboration can flourish.

In terms of institutional capacity, technological readiness, and innovation support—arguably three of the most important indicators of an effective research framework—China is found by the WEF to be a follower

**Table 6.3** Top ten PCT enterprise applicants, international phase, ordered by 2014 data

| *Rank* | *Applicant* | *Origin* | *2014 PCT applications* | *Change from 2013* |
|---|---|---|---|---|
| 1 | Huawei Technologies | China | 3442 | 1332 |
| 2 | Qualcomm | USA | 2409 | 351 |
| 3 | ZTE Corporation | China | 2179 | –130 |
| 4 | Panasonic | Japan | 1682 | –1157 |
| 5 | Mitsubishi Electric Corporation | Japan | 1593 | 280 |
| 6 | Intel Corporation | USA | 1539 | –332 |
| 7 | Telefonaktiebolaget LM Ericsson | Sweden | 1512 | 44 |
| 8 | Microsoft Corporation | USA | 1460 | 652 |
| 9 | Siemens | Germany | 1399 | 51 |
| 10 | Koninklijke Philips Electronics | Netherlands | 1391 | –32 |

*Source*: Based on data from WIPO PCT Review 2015 (Geneva: World Intellectual Property Organisation), p. 44

rather than a leader (see Table 6.4).[53] The OECD confirms these findings, showing China well below OECD average levels of performance for entrepreneurship, business innovation, and the provision of an effective scientific base. Chinese capacity for managing knowledge flows and achieving high levels of commercialisation of ideas through international co-patenting and international co-authorship is also considered to be weak.[54]

The areas of weakness for China are precisely the areas in which the WEF's latest report shows strengths in Europe, especially in Germany, Finland, and the UK, suggesting that collaborative opportunities for synergy with China could be wide-ranging if enterprise-level contacts could be initiated and sustained.[55] It is also instructive to dig a little deeper into the detailed analyses of the competitiveness report, as it makes for sobering reading from a Chinese perspective. China's transition from an economy that is efficiency-driven into one that is innovation-driven has not yet taken place. Whilst acknowledging China's strengths in maintaining a stable macroeconomic environment and the potential to harness a substantial domestic consumer market, detailed metrics show serious shortcomings in China's capacity for innovation in the generation of new ideas and the cultivation of what the report terms an "ideas ecosystem," weaknesses in

**Table 6.4** International competiveness in selected pillars for China compared with selected EU Member States, the USA, and other European economies with overall ranking in the top 20 of 140

| *Pillar country* | *Overall ranking* | *Institutions* | *Higher education & training* | *Technological readiness* | *Innovation* |
|---|---|---|---|---|---|
| Switzerland | 1 | 7 | 4 | 2 | 1 |
| USA | 3 | 28 | 6 | 17 | 4 |
| Germany | 4 | 20 | 17 | 12 | 6 |
| Netherlands | 5 | 10 | 3 | 10 | 8 |
| Finland | 8 | 1 | 2 | 13 | 2 |
| Sweden | 9 | 11 | 12 | 4 | 7 |
| UK | 10 | 14 | 18 | 3 | 12 |
| Norway | 11 | 5 | 7 | 7 | 13 |
| Denmark | 12 | 15 | 9 | 9 | 10 |
| Belgium | 19 | 22 | 5 | 14 | 16 |
| Luxembourg | 20 | 6 | 40 | 1 | 15 |
| *China* | ***28*** | ***51*** | ***68*** | ***74*** | ***31*** |

*Source*: Based on data from the WEF's Global Competitiveness Index in the World Competitiveness Report 2015–2016 (Geneva: WEF, September 2015), pp. 15–21

the ability to nurture talent through the national education system, and continuing problems in promoting firm-level technology absorption, well below the capabilities of leading EU economies. This inhibits the country's innovation-led growth strategies.[56]

China also exhibits weaknesses in fostering international collaboration in the generation of research outputs. Assessments show pronounced leadership by EU Member States, alongside the USA, in both internationally high-quality publications and cross-border collaborations involving authors affiliated to different institutions (see Fig. 6.4), although the latter performance of EU Member States is enhanced by their purely intra-EU cooperation.

In terms of quantity of researchers, China presents some contradictions. In absolute numerical terms, the number of researchers in the People's Republic has been growing steadily since 2001 and accounts for most of the increase for Asia as a whole.[57] However, absolute numbers are not the whole picture. As a percentage of full-time employed, the country's research specialists form a relatively small group within China's working population compared, say, to some EU Member States, and these numbers indicate the gap that still remains between China and the EU average level in regard to the depth of research expertise, which in turn affects innovation capacity in China.[58]

These various assessments serve to underline three related points. First, whilst China is approaching world leadership in terms of state-led

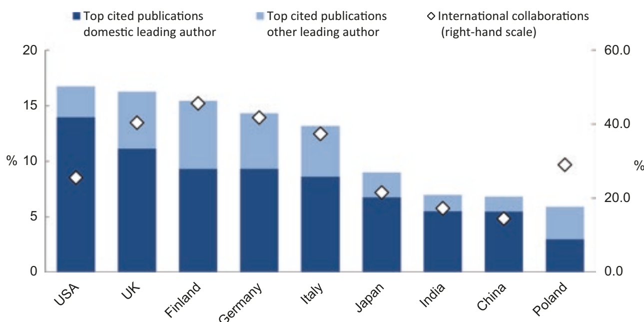


**Fig. 6.4** Collaborative outputs from the USA, selected EU Member States, China, and significant others as a percentage of published scientific publications—2003–2011. *Source*: Based on data from OECD Science, Technology and Industry Scoreboard, October 2013, p. 135 (OECD Publishing). See also *StatLink* data at http://dx.doi.org/10.1787/888932891606

investment and absolute R&D intensity, such purely quantitative leadership needs to be supplemented by other innovation drivers. These include policy support to improve the flow of finance to smaller entrepreneurial firms and promote the diffusion of ideas as part of encouraging a stronger innovation capacity in the economy, which are two areas where China's performance falls well behind that of more developed economies.

Second, there can be cause for optimism within the EU about the extent to which European firms and high technology centres continue to enjoy international recognition of excellence, and where EU capabilities far exceed anything offered by China. Whilst this should not be a cause for inaction, it does reflect a more nuanced picture of China's weaknesses and Europe's strengths, and acts as a rationale for further bilateral cooperation.

Finally, the areas in which China is seeking to improve its own innovation performance match the EU's strengths, which should provide ample opportunity for collaboration and synergy.

## Political Obstacles to Achieving Greater Cooperation

Given the potential for mutually successful collaboration in research and innovation between the EU and China, why is collaboration not yet more advanced? This section will examine the factors on both sides that continue to inhibit trust and partnership.

### *China's Legal Framework*

The WEF's Competitiveness Report (2015) highlighted China's relatively low performance for national institutions and business sophistication. In respect to innovation, these shortcomings impair the development of trust-building frameworks that are critical for domestic research activities to flourish and international collaboration to prosper: adherence to rule-of-law principles, the support and development of non-state venture capital funding, the protection of intellectual property, and the encouragement of open communications as a generator of innovative thinking. All of these issues are problematic for China and the country's inability to resolve them stands in the way of its evolution as an innovating power.

Implementing the rule of law is more than a key component of the EU's values-led dialogue with its international partners; it is also seen by many as an essential prerequisite for a properly functioning market economy. The President of the Asian Development Bank (ADB) has made the

point unequivocally that "the Rule of Law is essential to the economic development of our region," underlining that the government needed to be both transparent and accountable for its actions and to offer a legal framework to which all entities, including the government, must abide as the "fundamental building block of market economies."[59] China does not yet live up to this definition. Whilst the Party leadership has given some attention to the rule of law, most recently at the Fourth Plenum of the CCP in October 2014, there has been no sign of progress on the fundamental issue, the prevalence in government decision-making of legal instrumentalism, or "rule by law," whereby the law is effectively subservient to the interests of the Party-state.[60]

Many of the solutions to China's economic challenges—whether improving the efficiency and legal compliance of SOEs, controlling pollution, encouraging more balanced, consumer-led economic growth, or eliminating the waste of corruption—are dependent on a stronger commitment to rule-of-law principles.[61] Senior decision-makers in the EU would add that China's defensive attitude towards knowledge sharing, along with continuing question marks over the legal protection of trade secrets and enforcement of intellectual property rights, are key weaknesses that inhibit meaningful collaboration and trust-building between individuals and companies from different cultures.[62]

The 2012 World Bank report on China 2030 echoes these sentiments, whilst acknowledging the progress that has been made by China in penetrating global markets in a number of highly visible sectors. The Bank highlights the hesitancy that can characterise Western corporations when senior managers cannot trust prospective Chinese partners to protect their intellectual property and when pressure to transfer commercially valuable technology to China is seen more as a demand of the Chinese Party-state to support the indigenous sector than a sound commercial move. The Bank maintains that "[i]nnovation policies need to establish greater trust between the government and foreign investors and stronger institutions that validate and operationalize the mutuality of interests."[63] China's innovation capacities may be constrained unless these shortcomings are seen to be overcome, whatever priority China and the EU place on achieving higher levels of mutual cooperation.

The legal system is not the only institutional obstacle to Chinese innovation. Access to funding for domestic Chinese firms has been a long-running issue. Major SOEs control the banking sector and dominate access to lending to an extent that stifles SME development in the absence of an effective private venture capital market. The Third Plenum conclusions also recognised that a number of high-value innovation-led sectors—such as

telecommunications and civil aviation—needed to become more open to domestic (if not foreign) competition, but left open the question of how such a competitive environment could be created.[64] Plans were announced in September 2015 to move ahead with mixed ownership models in SOE-dominated sectors, but the pace of such change remains unclear, and the degree to which these reforms could lead to a genuine dilution of SOE power that would motivate increased private sector activism in these sectors continues to be a matter of debate.[65] Without a more determined and detailed response from China's leadership to address some of these failings, it is difficult to map out where and how European collaboration could begin to foster higher levels of innovation and invention in China.

### *The EU's Capacity to Act as a Partner*

Not all the problems in this area begin and end with the Chinese. The way in which innovation and research policy is handled within the EU adds complexity and multiplies the difficulties. Two particular aspects stand out—contradictory policies within different parts of the EU institutions, on the one hand, and competing Member State initiatives that may undermine Union-level negotiations on the other. Both issues illustrate the problems facing the EU in formulating a coherent policy response to China, although recent initiatives to ensure more effective communication between different European stakeholders may improve matters.

The Key Enabling Technologies (KETs) initiative is an example of ambiguity in EU objectives. It has high visibility in the EU. Premised on the need to foster greater levels of investment and achievement in competitive technologies within Europe's dwindling manufacturing base in apparel and technology hardware, proponents of the policy support a major shift towards directly competing with countries such as China in incremental innovation and generating commercial outputs from experimental research. This would include a reduction of financial support for Europe's current strengths in basic research, in what the proponents describe as "unbalanced European public investment."[66] Such moves may reflect genuine needs in manufacturing areas whose market share and global competitive position have been challenged by re-emerging economies such as China, but care is needed not to undermine the EU's comparative advantage over China in basic research capabilities and blue-sky innovative thinking.[67] The opportunities for collaboration with China outlined elsewhere in this chapter hinge on finding complementarity of competences rather than encouraging competition. The fact that the EU–China ICD

may be evolving in one direction and the KET's strategy in another would appear to call for more effective strategic coordination to ensure that the EU's current advantages and opportunities are not squandered.[68]

Inconsistent policy at the EU level is not the only problem. In its political relationship with the EU, China has been adept in achieving its goals through carefully working at both Union and Member State levels in order to achieve maximum leverage. The solar panels case in 2013 was an example of China using leading Member States to push Union decisions towards an outcome that was more in its interests (and those of one or two Member States) rather than the Union's as a whole. Innovation and research cooperation, which are an issue of mixed competence under EU law, overlap with trade and investment policy, which are a matter of exclusive EU competence. It will be important that the Member States ensure that their national research and innovation strategies are at least coordinated with Union objectives to prevent China using the variable geometry of the EU's political structure to further its advantages over European interests. Recent analysis by the European Commission has tended to confirm that the EU is still searching for an effective policy mix—at national level, between Member States, and between Member States and Union level. This has profound implications not only for the Union's external policy towards China but also for its capacity to take strategic decisions about its own industrial future.[69]

The EU therefore faces a number of challenges in trying to realise its own potential in S&T Policy. The lack of effective coordination between Member States and the Union over innovation policy is exacerbated with respect to relations with China as individual states see themselves as competing to attract much-valued Chinese inward investment. China has become increasingly adept at recognising and exploiting differences in policy priorities and implementation strategies between Member States—and sometimes even between different departments within the European Commission itself (the KET report is an exemplar of this problem).

Creating a coherent policy framework at the EU level for engagement with China in this area is seen by EU policymakers as being just as important as deciding which sectors to include as part of the proposed cooperation. The EU executive is simultaneously working on improving internal communications with and between Member States, on the one hand, and developing a bilateral dialogue with China on the other.[70] Pan-EU collaboration at the strategic level is still emerging, with initiatives such as the ERA, where the Commission has identified willingness to deepen cooperation in national research and innovation strategies in only half of the current Member States. Nevertheless, this is still work in progress, which

may help to explain why progress in terms of practical enterprise-led cooperation projects which illustrate how EU-level initiatives could work has been relatively modest.[71]

## Conclusion

Evidence presented in this chapter shows that despite fundamental differences in economic structure, China and the EU actually share many of the same strategic goals in respect to policies nurturing research, development, and innovation capabilities, whilst each has to learn to co-exist in the same challenging international environment. Both economies see their future success as dependent on an ability to capture markets in KETs that can be licensed, turned into products, and distributed both domestically and internationally.

China is under increasing pressure to rebalance the country's economy and make further headway in achieving the policy objectives of its S&T Policy. Analysis of international metrics for research and innovation offered in this chapter shows striking differences between the capabilities of China and the EU, illustrating that in many areas of scientific endeavour, the Chinese continue to be followers rather than leaders. Complementarities of skills clearly exist for shared research with China, as European success in basic and blue-sky invention match China's capacity for incremental innovation and the practical application of existing ideas, often specifically customised to add value in a Chinese environment. For both sides, therefore, such cooperation would present opportunities for both research collaboration and outward investment.

Moreover, European economies are generally more positively disposed towards building closer ties with China. For example, in the UK, there is clear political will to consider technological collaboration that extends into such sensitive infrastructures as nuclear power generation and telecommunications, as evidenced by agreements with the Chinese in 2015. By comparison, China's partnership with the USA is often inhibited by security concerns, geopolitical tensions, and regional rivalry. The EU does not suffer from these conditions to anything like the same extent and could offer the prospect of a markedly more open and potentially more cooperative partner. In a number of areas of mutual interest, there are genuine possibilities for building on individual project success stories, if underlying obstacles could be overcome.

However, despite these opportunities, and the recent efforts to set EU–China research and innovation on a steady course, there is very little

evidence to indicate that the underlying technological, political, and structural inhibitors that have been outlined in this chapter can be removed in the foreseeable future, without which it remains difficult to see how the potential that does exist can be successfully realised.

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CHAPTER 7

# Monetary Affairs

*Key questions:*

- *Are the EU and China becoming international monetary powers?*
- *Do China and the EU have common interests in the monetary field, and how far do they cooperate?*
- *Why is monetary policy part of Chinese economic reform?*
- *Is China's full integration into the international monetary system possible without political change?*
- *How will the growing international role of the RMB affect the euro and the EU?*

"Great powers have great currencies," said Robert Mundell.[1] The EU and China each have international ambitions for their respective currencies but also major political hurdles to overcome before they can realise them. This chapter will explore these monetary policy challenges and consider to what extent their interests and goals in this area, sometimes coinciding, sometimes directly opposed, affect their broader economic relationship. The EU and China start from very different positions.

The EU, with an adolescent (15-year-old) single currency, is a partial power in the monetary field. Despite its inclusion into the SDR, the international reserve asset managed by the IMF, since 2001, and its position as the second most widely used denominator of international economic transactions after the US dollar, the euro's international standing is being eroded by continuing doubts about the durability of the euro project and

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the Eurozone's economic policy. The EU also remains a multicurrency Union: six EU Member States do not yet qualify for use of the euro, although they have formally undertaken to adopt it, and three others (the UK, Sweden, and Denmark) are committed to maintaining their monetary independence.

China, on the other hand, has all the powers necessary for an effective monetary policy but faces handicaps in achieving international recognition for the RMB. Its monetary system, characterised by a managed exchange rate and relatively closed financial markets, is fundamentally different from those of the developed economies, where markets have generally determined exchange rates since 1971 and restriction of capital movements is only resorted to in emergencies (such as in Greece during the 2015 "Grexit" crisis). Whilst the IMF decided in November 2015 to integrate the RMB as a component of the SDR from October 2016, that is only one step, albeit an important one, in the RMB's progress towards wider international recognition and use.

The Chinese leadership has recognised that China will have to change policy if its currency is to play a bigger role in the international monetary system. It has liberalised access to the RMB for certain institutional investors. Further reform, however, would require the Chinese authorities to accept a less politically driven monetary policy and less control of financial markets. They would have to be ready to reduce, if not abandon altogether, control of exchange rates and international capital flows. At the same time, they would need to reform China's financial markets, accepting the erosion of the dominant position of state-controlled banks, dismantling the direct control of interest rates, and allowing greater competition from non-Chinese banks and other financial service providers. This will be difficult both technically (effecting radical change in financial markets whilst avoiding short-term economic instability) and politically (accepting loss of political control and confronting the vested interests in China opposed to reform).

Given China's weight in the international economic system, as the world's second biggest economy, China's international partners, including the EU, have much at stake in this aspect of China's economic reform. Wider international use of the RMB will improve the efficiency of financial markets and contribute to greater stability of the world economy, reducing the risk of shocks from arbitrary or strategic changes in exchange rates and of distortions resulting from overdependence on a single dominant currency, the US dollar. Monetary reform will also benefit China, by reinforcing the economic links between China and the rest of the world through two-way investment, increasing the efficiency of Chinese financial markets and reducing

the exchange costs to China of international trade and investment.[2] Greater international weight for the RMB could, however, lead to increased volatility for the euro and reduction of the European influence in the IMF unless there is more progress on the Eurozone's economic policy.

This chapter will first review the international standing of the euro and RMB today and then describe how China and the EU interact on monetary issues. A third section will analyse the progress made in Chinese monetary and financial market reform and the political difficulties in proceeding further, as well as the EU's debate about its own monetary and economic policies. A concluding section will assess the repercussions of greater integration of the RMB into the international monetary system for the world economy, the euro, and the EU.

## The International Standing of the Euro and the RMB

The euro is already a global currency, and the RMB has the potential to become one, although it is currently much less widely used. Key indicators of the international importance of a currency include its use in foreign exchange operations and trade-related financial transfers, the value of internationally tradable financial instruments denominated in the currency, and its use as a store of value, in particular as a reserve currency by central banks. The situations of the euro and the RMB are today very different.

Against the first criterion, use of a currency in foreign exchange and trade-related payments, the US dollar and, to a lesser extent, the euro are the world's leading currencies by a long way. The dollar is used in 87 % of foreign exchange operations, the euro in 33 %.[3] By contrast, the RMB represents a very small share of international transfers (1.6 %), even if its use is growing steadily, particularly in countries that trade extensively with China; it accounts for more than 10 % of all payments in many of them (with the notable exception of the USA).[4] Traditional means of international trade finance, such as letters of credit, are mostly denominated in dollars (80 %), but the RMB overtook the euro as the second most widely used currency in 2013. A small but fast-growing share of China's external trade (about 25 %)[5] is expressed in RMBs. The currency is made available to foreign countries for trade purposes within pre-agreed limits under international currency swap arrangements between the People's Bank of China (PBoC), the Chinese central bank, and its foreign counterparts. At the time of writing, 32 swap agreements have been concluded, including with the ECB and the central banks of several EU Member States.[6]

The situation regarding denomination of internationally traded financial instruments is similar. US dollar-designated assets account for nearly two-fifths of the world's total ($54 trillion) and euro-designated instruments another fifth ($29 trillion).[7] RMB-designated instruments are negligible by comparison, at about $0.25 trillion.[8] Access to the euro-designated assets is open, whereas access to RMB-denominated assets is strictly controlled, notably by the Chinese rules on qualified investors (under the Renminbi Qualified Foreign Institutional Investor Scheme), which limit participation to large financial institutions within national quotas fixed by the PBoC.[9]

The euro has been used as a reserve currency since its first appearance, although it remains a poor second to the dollar. In 2014, it accounted for 22 % of world currency reserves, compared to 63 % for the US dollar (and 5 % for the pound sterling).[10] A number of central banks in emerging economies, including China, have built up substantial euro holdings, in order to reduce their dependence on the dollar, although BIS rules on transparency allow central banks to withhold precise information on their foreign reserves. Chinese restrictions on the convertibility of the RMB on the capital account mean that that currency is hardly used as a reserve currency, although the inclusion of the Chinese currency in the IMF SDR from October 2016 is expected to promote its wider use. Today, 38 central banks out of the 188 IMF member countries hold RMB reserves, amounting to 1 % of global reserves.[11]

Despite China's importance as the world's second largest national economy, Chinese regulations have largely prohibited the use of the RMB outside China for capital transactions, although there has been some liberalisation in the past decade as part of China's promotion of trade and outward FDI. Political control of the exchange rate has been an essential part of the Chinese economic system since the founding of the People's Republic, along with regulation of interest rates and a banking sector dominated by state-owned banks. For most of the three decades since China's opening up to the global economy, the RMB has been pegged to the US dollar, although since 2005, a creeping peg system within narrow limits for daily fluctuation has applied.[12]

The fundamental differences in availability and use between the euro and RMB have been reflected in the operation and voting rules of the IMF. Under the decisions made by the Fund in 2010, the euro makes up 37 % of the value of the IMF SDR, the international reserve asset made available to the Fund's members, compared to 42 % for the US dollar, 11 % for the pound sterling, and 9 % for the Japanese yen.[13] The RMB

has up to now not been included in the composition of the SDR, despite China's weight in the world economy, because it has not been considered to be a "freely usable" currency, given the restrictions on its convertibility. A further motive for not including the RMB within the SDR has been the Chinese policy of pegging the RMB exchange rate to that of the dollar, allowing slow fluctuation over time but resisting any short-term market-driven changes. Some in the IMF, including the current Managing Director, Christine Lagarde, had suggested that the shadowing of the dollar by the RMB meant that inclusion of an RMB component in the SDR would reinforce rather than attenuate the international influence of the dollar.

As China's economic weight has grown, however, there has been increasing concern within the IMF about the political risks of exclusion of the RMB from the SDR, which could fuel resentment in China at the reluctance of the developed economies to allow that country full participation in the international monetary system. This is likely to have been the underlying explanation of the IMF Executive Board decision of November 2015 to include the RMB within the SDR from October 2016. The technical justification of this policy change was that China had taken sufficient measures to ensure the IMF and its central bank members "sufficient access to onshore markets to perform Fund-related and reserve management transactions without serious impediments."[14] In other words, the RMB was judged to be freely usable by other central banks, even if liberalisation of China's capital account was much more limited for other financial institutions and individual investors. The situation of the RMB, however, remains fundamentally different from that of the freely convertible currencies that are part of the SDR basket already. As the definition of what constitutes a freely usable currency under IMF rules is vague, a wide margin of discretion was left to the IMF Executive; indeed, other currencies have been included within the SDR basket at a time when their governments still restricted capital movements, although not to the extent that China does today.

Whatever the motives for the IMF's 2015 decision, it represents a major if largely symbolic change in international currency rankings, placing the RMB, which will constitute nearly 11 % of the value of the SDR from October 2016, ahead of the pound sterling and Japanese yen (both at 8 %) and reducing the share of the euro substantially (from 37 to 31 %), the US dollar staying practically unchanged at 41 %.[15]

Voting rights in the IMF, on the other hand, where China has only 3.8 % of the total, compared to a total of 31 % for EU Member States and 16.7 %

for the USA, have been slower to adapt and have been a highly contentious issue for China over the past few years.[16] A reform of the IMF's governance was agreed in 2010, as part of which China's voting rights would have been (slightly) increased and those of EU Member States and the USA decreased, but this agreement could not be implemented because of the refusal of the US Congress to ratify it until December 2015.[17] This five-year delay in reinforcing China's position illustrates how much political as much as technical factors can influence the outcome of international monetary negotiations.

Meanwhile, the EU's response to the post-2008 economic and financial crisis has put a brake on international use of the euro. The credibility of the European single currency has been affected by doubts about management of the economic, banking, and sovereign debt situation in several EU Member States since the financial crisis, beginning with the so-called peripheral countries (Greece, Ireland, Portugal, and Spain) but also extending into two of the biggest Eurozone economies, Italy and France.

The EU has been energetic in responding to the crisis. It adopted over the period 2010–2013 a series of measures designed to introduce more collective economic management among the 19 Member States in the Eurozone and to reinforce financial market and banking regulation across the whole EU. For the Eurozone, new rules limit public deficits and establish procedures for collective supervision of national budgets. Banking supervision for the entire EU has been strengthened and coordinated. The ECB is responsible for supervision of 123 banking groups that account for 85 % of Eurozone banking assets, and common EU rules have been agreed for the supervision of other financial service providers (stock exchanges, dealers, hedge funds, and insurance companies) through new European-level supervisory authorities.[18] An array of other measures, ranging from procedures for the collective resolution of bank failures to limits on the remuneration of bankers, forms part of this financial reform package.

Notwithstanding these efforts, uncertainty about economic recovery in the EU and the ability of weaker Eurozone economies to reduce their public deficits has raised questions about the ability of the EU to emerge from the crisis. In mid-2015, Greece appeared unable to meet its international debt obligations and, even though it chose to make further budget cuts to obtain further EU financial support and stay within the Eurozone, the viability of the latest EU rescue package and the need for further adjustment to it by writing off a part of Greece's debt is still in question at the time of writing. Public disagreement between Eurozone members about how to stimulate economic recovery, between the austerity school led by Germany, on the one hand, and the deficit finance school led by

France and Italy, on the other, has added to the uncertainty. Doubts about the quality and stability of European economic management inhibit wider international use of the euro: recent ECB figures indicate that the euro is less widely used as a reserve currency today than at its peak (22 % of international reserves in 2014, compared to 27 % in 2009).[19] This said, China has been a strikingly vocal and visible supporter of the euro.

## EU–China Economic and Monetary Cooperation

China and the EU are very different types of international actors (one a state, the other a partnership of states), at different stages of economic development and holding different views about the role of the state in monetary affairs. They have overlapping interests, however, which lead them to maintain regular contacts. Both are concerned to maintain stability and predictability in international economic management, and whilst the re-emergence of China as an economic power presents a challenge to the existing order of the international monetary system, one in which China's gain is widely seen as Europe's loss, both sides appear concerned to manage the transition as smoothly as possible. Many in Europe share China's wish for a more balanced international monetary system that is less dominated by the dollar and the state of the US economy. In this policy area as in others, however, different views and interests within the EU reduce its ability to act as a partner for China.

The EU and China have for many years maintained regular high-level contacts on both macro-economic management and monetary affairs. The macro-economic dialogue is conducted by the European Commission for the EU and the Ministry of Finance, the NDRC, and the PBoC for China, and takes the form of an annual review of economic developments on both sides—a largely technical exchange of information between senior officials on the state of each economy and recent policy developments, intended to reinforce mutual confidence about the quality of economic management. A separate dialogue on monetary affairs is led on the EU side by a "Troika," made up of the Commission, the European Council, and the ECB, and on the Chinese by the PBoC and the Ministry of Finance. This is a more intensive process than the macro-economic discussion, involving annual plenary meetings at central bank governor level and twice-yearly working-level meetings between senior officials. The plenary meetings are more political in nature, involving exchange of confidential information about monetary strategy and exchange rate policy. A programme of EU technical assistance, in which the ECB provides advice

and training to PBoC staff about money market operations, supports the policy discussions.[20] Officials involved in these discussions, however, freely admit that they remain relatively technical and are not intended to change the way policy develops on either side.

More important as an indicator of China–EU cooperation in the monetary field, seen from the European side, has been the practical support offered by China during the height of the euro crisis, in 2008 and 2009, when the Chinese leadership, and notably the then Chinese Premier Wen Jiabao, went out of its way to give public support to the single currency. One senior European official was quite blunt about China's importance:

> China has been perhaps the strongest international supporter of the euro during the recent crisis, more than the United States; it didn't buy huge quantities of government debt but made all the right noises to express its confidence that the EU would deal effectively with the crisis.[21]

Another senior political figure on the European side has asserted that China was ready to purchase the government debt of some peripheral EU Member States at a time when Norway and some EU Member States were selling it.[22] Although Chinese purchases of the government stock of certain Member States affected by the crisis, such as Portugal, Italy, and Hungary, are estimated to have been relatively small, the Chinese government has repeatedly made a case for confidence in the euro through official visits and public announcements by its leaders. The underlying reason for that is China's dissatisfaction with the current international monetary system and its wish for greater political balance within it, combined with a wish to have access to an alternative store of value to the US dollar for its foreign reserves.

China's economic emergence has coincided with an intensification of the international debate about the future of the international monetary system following the post-2008 financial crisis. As incumbents in the international monetary system accounting for nearly a third of IMF votes, the EU Member States have reservations about the arrival of China as an emerging monetary power intent on introducing change that will necessarily be at the expense of European influence. Nevertheless, the EU, like China, is affected by US monetary hegemony in the post-1971 international monetary system, often described as the "floating dollar" system. Unilateral monetary policy decisions by the USA (such as the decisions by the US Federal Reserve during the post-2008 economic crisis to maintain near-zero interest rates and to pursue "quantitative easing" as

a means of promoting economic recovery) have a significant economic impact on the rest of the world, particularly in terms of interest rates. At the same time, the US benefits from the "exorbitant privilege" (a term coined by a European, Valéry Giscard D'Estaing, when Finance Minister of France)[23] of being able to borrow from the rest of the world in its own currency because it is so widely available (roughly 60 % of the global stock of US dollars circulate outside the USA).[24] Not only does the USA reduce the cost of its borrowing in this way, it also benefits from the impact on exchange rates of safe-haven demand for its currency and the high yield of foreign investment made in these easily borrowed dollars.[25]

Other regions in the world economy, including the EU, would prefer, at least in principle, a more multipolar international monetary system, in which several leading currencies contributed to the stability of the international monetary system, and that influence over the system's future development was more evenly distributed. The five-year opposition of the US Congress to the 2010 IMF reform of the SDR and voting powers is a striking reminder of US influence over the system.

Despite its underlying interest in system change, however, the EU is once again divided. The UK is a major IMF stakeholder in its own right, with a currency that forms part of the SDR, and tends to take a more Atlanticist position that defends the current system. Like Germany, it supports the maintenance of the current IMF criteria for recognition of international currencies, which put major emphasis on a currency being freely usable (although the recent IMF agreement to include the RMB in the SDR has shown that that concept is elastic). France, on the other hand, like China, is more open to the idea of managed rather than market-driven exchange rates and, during the presidency of Nicholas Sarkozy, took a high-profile stance in favour of international monetary reform, urging a multipolar system rather than reliance on the US dollar.[26] Meanwhile, the policy of the ECB regarding the international rise of the RMB appears to be strictly neutral, the same as that regarding the international use of the euro, that is, to "neither hinder nor promote."[27]

The EU is not well placed to be a powerful actor in international monetary affairs. International influence is ultimately dependent on the clarity and successful communication of economic as well as monetary policy, which the EU lacks more than most. The next section will show, however, that China, too, suffers from an ambivalent policy in financial and monetary affairs and has difficult policy choices to make.

## Policy Intentions and Difficulties

### *China*

At the level of general principles, the Chinese authorities appear to have recognised that a convertible currency opens up possibilities for real-time economic adjustment to changing market realities and a sounder long-term basis for international trade and investment, whereas controlled exchange rates bring risks of rigidity, chronic misalignment of the exchange rate, and constraints on international investment and growth. The World Bank/China State Council report on China 2030, issued in 2012, suggested that greater use of the RMB as an international currency would provide more economic stability for China than a managed exchange rate.[28]

The new Chinese leadership confirmed its intention to pursue the goal of RMB convertibility in the Third Plenum conclusions. The Party's objectives, however, were expressed in language that reflected a prudent approach. The direction of travel—towards convertibility—was clear but not its speed. Thus, the Third Plenum conclusions speak of "perfecting mechanisms for the formation of markets for RMB exchange" rather than achieving full convertibility, "moving interest rate marketization forward" rather than achieving it, "raising the extent of convertibility of cross-border capital and debt financing" rather than abandoning constraints altogether, and "establishing and completing capital flow management systems under prudential management frameworks." All of this falls some way short of allowing free capital flows.[29] This carefully managed approach is, it must be said, in keeping with the recommendations of the World Bank's 2012 report which said that:

> In the case of China… a relatively prudent approach, stretching over many years, is recommended in transitioning safely to a more open and efficient financial and exchange rate system.[30]

Since 2013, the Chinese government has put into place various measures to open up international access to RMB-denominated assets, allow greater flexibility in the RMB exchange rate, and increase the possibilities for convertibility of the capital account. These include:

- permitting the trading of RMB-designated bonds in financial markets outside mainland China (Hong Kong, Singapore, London, Abu Dhabi) up to a given ceiling;

- allowing greater freedom for international transactions in RMB-denominated assets in the newly created free-trade areas within China;
- broadening the daily limit for fluctuation of the RMB exchange rate;
- allowing two-way purchases of Chinese and international financial assets through the Shanghai–Hong Kong and Schenzen–Hong Kong Stock Trains linking the Hong Kong and Chinese stock markets, inaugurated in 2014–2015; and
- agreeing currency swap agreements between the PBoC and other central banks to provide local markets with access to RMBs.

Whilst encouraging wider international use of the RMB, these technical adjustments fall short of what would be necessary for full convertibility of the Chinese currency.

To take the exchange rate as an example, the daily rate still fluctuates within a narrow band set by the PBoC, rather than being the outcome of supply and demand on open foreign exchange markets, and, as events in August 2015 showed, can be subject to sudden and arbitrary government interference. Although the permitted daily fluctuation has been increased from 1 to 2 %, the opening level is determined by the PBoC and, until August 2015, usually reverted to the initial, politically determined reference level rather than reflecting the previous day's closing price.[31] Although the RMB was allowed to appreciate up to 30 % against the dollar between 2005 and 2014, it was judged by many to be significantly undervalued. There have been times when currency management by the Chinese government has been blatant. From January 2008 to December 2009, the PBoC maintained a constant dollar/RMB exchange rate in order to minimise disruption of China's exports during the peak of the financial crisis. The decision of the PBoC, on 11 August 2015, to devalue the RMB by 1.9 %, a measure that was entirely unexpected after ten years of barely perceptible daily changes, provided a second example. Interpreted as a clumsy attempt to improve China's trade competitiveness in the face of upward pressures on the RMB exchange rate during 2015, this incident damaged international confidence in the Chinese leadership's Third Plenum commitment to let the market become the decisive element in economic management and renewed concern about the risk of unpredictable economic management in China.

Achieving wider international acceptability of the RMB does not only depend on external perceptions of China's economic policy. It is also related to structural factors such as the quality and depth of the domestic

financial market and sufficient guarantee of the rule of law. Meeting these requirements will, for China, involve fundamental change, not only in terms of opening up its financial markets but, above all, reviewing the management role of the State and the Party in the Chinese economy. Three examples may serve to illustrate the extent of the political challenge for China.

(a) *Removal of controls on currency flows*

Full convertibility implies that national authorities accept exposure to the market's assessment of the quality of their economic policy. Investors faced with market conditions likely to generate poor returns, such as high inflation, negative real interest rates, or imminent credit restraint, would be free to invest overseas. In an economic upturn, the absence of exchange restrictions may facilitate inward investment and boost economic growth; in a downturn, however, it may expose governments to capital outflows which make the economic situation worse. Whilst the IMF rules allow countries to take action to curb capital flows in an emergency, the norm would be to tolerate them. Moving from the system of total control that the Chinese government enjoys today to one that would tolerate much higher levels of capital movements will be difficult. Many observers recognise that the enormous size of the Chinese market, the level of international investment interest in it, and the potential scale of capital movements into and out of China under a liberal currency regime all mean that the Chinese government's resolve to move slowly and carefully in this area is understandable. The IMF Governor for China, Zhou Xiaochun, spelt out in a speech to the IMF in April 2015 that China would continue to proceed slowly and cautiously and emphasised that its final goal was "managed" RMB convertibility rather than full convertibility.[32]

(b) *Liberalisation of interest rates*

In a market economy, interest rates need to reflect economic realities in order to allocate resources efficiently and retain or attract investors. Liberalisation of interest rates in China, however, would mean that the current system of highly regulated interest rates, under which real interest rates on private savings are negative, margins between savings and loan rates for state-owned banks are wide, and interest on loans to privileged borrowers, such as state-owned companies, is kept artificially low, would

have to be abandoned.[33] Such a change would undermine a key instrument of Chinese industrial policy, whereby economic development is supported by preferential access to capital controlled by the State. It would also, of course, threaten the viability of the many SOEs at national, regional, and local level that have benefited from cheap capital. These companies are not only important providers of employment but also a major source of income for the state and Party; the Third Plenum decided that their transfers to the government are to be increased by 2020.[34]

(c) *Allowing competition in financial markets*

Wider international use of a currency depends on the holders of assets in that currency knowing that their assets can be easily traded, through well-developed and open markets for foreign exchange dealing, banking, and brokering, in which multiple holders and traders of financial assets are able to compete. Introducing such an environment into China, by gradually allowing new domestic and foreign service providers to enter the market, would challenge the dominance of the four state-owned (and Party-controlled) banks, as well as state-owned financial intermediaries, whose behaviour is as much subject to political direction as based on commercial considerations.[35] This would dramatically reduce the power of the government to direct financial resources to strategic priorities identified, for example, in the Five-Year Plan. It would also reduce the profitability of the state-owned banks.

These examples suggest that the reforms necessary to achieve greater RMB convertibility can only be achieved by changes that will put the current Chinese economic system under stress, if not at risk. Abandoning the policy instruments that have been at the centre of China's economic management to date would be a major political risk. Blame for job losses or falling competitiveness of national champions in some economic sectors would, at least in the short term, fall on the Party and damage its political standing. Whilst there was no widespread recrimination in China following the Asian economic crisis in the late 1990s, the situation today is different. Not only are the numbers of urbanised workers much higher but the government and Party have been claiming success in economic management for much longer. Any government would approach a transition towards currency convertibility with care, but the Chinese government, which claims the credit for China's economic growth and assumes the responsibility for successful economic reform, has more to lose in this

process than most. This makes it all the more likely that implementation of convertibility of the RMB will be prudent and gradual.

There are different views within China about the timescale for achieving RMB convertibility. For the drafters of the 2013 Third Plenum conclusions, the measures needed to accelerate convertibility (rather than to achieve it fully) are part of the plan to make China a "moderately prosperous society" and should be in place before 2020.[36] A senior official of the State Administration for Foreign Exchange (SAFE), speaking at a conference on capital flows in 2013, was more vague, speaking of complete liberalisation of capital flows "in a few years."[37] Any timetable for full convertibility of the RMB, however, is highly speculative, and the Chinese authorities avoid predictions, as did Zhou Xiaochun in his statement to the IMF. The gap between promises and delivery in this area has already proved to be wide: liberalisation of interest rates was first announced as a goal for China in 1996, but there has been little progress towards it over two decades.[38]

The forces resisting change within China are substantial. The beneficiaries of the current system are not only economic interests, such as the SOEs, the state banks, and their employees, but also powerful bureaucracies, such as the NDRC, the Ministry of Finance, and their counterparts at provincial level, whose influence over the economy and bureaucratic power would be curtailed by reform. Party managers would not be enthusiastic about the reduction of Party income that would result from lower profitability of SOEs. Compared to these powerful vested interests, the beneficiaries of reform, such as consumers, domestic savers, and private businesses, are dispersed across society, badly organised, poorly represented in the system, and politically lightweight.

Along the path towards RMB convertibility, therefore, the Chinese government may prefer to sacrifice the potential advantages of reform in order to preserve the benefits of control, such as clear priority setting and the ability to safeguard jobs or other forms of economic stability. The reaction of the Chinese authorities to slowing economic growth in China since 2014, in the form of providing additional credit to an already heavily indebted economy or intervening to avoid bankruptcies of failing companies, is one illustration of loss of political nerve and in the face of adverse market developments. Even more striking was the reaction to the stock market collapse of mid-2015, when the Shanghai index lost 40 % of its value in few weeks. Official bans on short selling of shares, instructions to stockbroking companies to invest, and the arrest of some prominent brokers for conspiracy created a chaotic situation in which the basic concepts

of investment and trade and the rights of investors were brushed aside. Actions such as these led some financial analysts to suggest that the RMB's chances of being taken seriously as a reserve asset had gone backwards.[39]

The July 2015 events on the Shanghai stock market are a reminder that creating the conditions for international use of the RMB is not just a technical matter. It also depends on developing international confidence in the quality of Chinese economic management, on replacing state power by market forces and on guaranteeing the rule of law. As the analysis of Chinese economic policy in other chapters has already indicated, China has a considerable way to go in this respect. The strong terms in which the Chinese government has in the past two years condemned "constitutionalism," the political movement in China which seeks to assert the application of rights already embedded in the Chinese constitution and insists that the Party should take account of them, is not a promising sign. The introduction of market disciplines and application of the rule of law are far from complete, despite the repeated commitment of the Chinese leadership to deliver both.

### *The EU*

The EU, too, faces difficult choices in managing its own economy and single currency which affect its relationship with China.

Barely perceptible growth in several Member States and high levels of unemployment, especially for the young, have led to unprecedented measures to promote economic activity. The ECB has since December 2014 embarked on its own version of "quantitative easing" through a programme of massive purchases of securities, including government bonds, in order to drive up stock markets, increase asset prices, reinstall market confidence, and avoid deflation.[40] In parallel, the European Commission in November 2014 proposed an Investment Plan for Europe, a coordinated programme of publicly assisted investment in renewal of infrastructure, new energy and communications networks, research and innovation, based on €315 billion of EU and national capital contributions designed to generate a much higher level of private capital lending.[41]

Opinions within the EU are divided on both initiatives. Some Member States, especially Germany, are reluctant to allow even a minimal level of deficit financing by Eurozone members and have questioned the legality as well as the wisdom of some support measures envisaged by the ECB. The European Court of Justice in a ruling of February 2015 appeared to

support the legality of the ECB measures but left open its position about possible additional measures.[42] The Commission's Investment Plan for Europe received widespread political support, in the form of EU agreement to create a new European Fund for Strategic Investment (EFSI) which was planned to start operating before the end of 2015, but there remain reservations in some quarters about the adequacy of the Fund. China, however, has seen the Fund as a political opportunity and at the 2015 EU–China Summit pledged to contribute to EFSI and suggested that its investment programme be coordinated with the One Belt One Road initiative.

Meanwhile, the attention of Eurozone economic ministers has been largely devoted to containing and overcoming the euro crisis, with the threatened default of Greece on its international financial obligations in 2015. Although a chaotic departure of Greece from the Eurozone was averted, following fresh elections in Greece, the divisions of opinion over how to manage the Greek crisis, and in particular the disagreement between those Member States in favour of writing off part of the Greek debt and those insisting on full repayment, has underlined how far the EU still has to go in building the political and fiscal union necessary to support its monetary union.

A currency union with such a poor track record may not be the most effective advocate of monetary and economic reform in China. The political differences that have delayed Eurozone agreement on a common policy for economic recovery are deeply entrenched. Advice from a disorganised and disunited Europe is likely to be politely listened by the Chinese authorities but no more. Only if the Eurozone countries manage over time to implement their announced policies on management of sovereign debt, the creation of a banking union, and more closely coordinated economic policy is the euro likely to be seen by China and other economies as an attractive alternative to the US dollar for savings and currency reserves.

## How Will Integration of China into the International Monetary System Affect the EU and the Euro?

China's dilemma over the choice between the potential economic benefits of liberalised financial markets (such as higher levels of foreign investment to generate restructuring and economic growth and an exchange rate that sends the right economic signals) and those of economic control

(mitigation of the effects of short-term economic shocks and the ability to direct financial resources towards economic priorities) is deeply political. The choice between a market-based and a control economy is at its most stark in the area of monetary policy and financial markets. Unresolved policy differences within the Chinese leadership are reflected in the ambivalent language of the Third Plenum decisions, which promised a decisive economic role for the market at the same time as a dominant role for SOE's. This suggests that the conditions necessary for wider international use of the RMB may be slow in coming. Assuming, nevertheless, that the RMB will, over time, play a much bigger role in the international monetary and payments systems, what would that mean for the global economy and Europe and China in particular?

The positive effects would be substantial. At the global level, there would be a lower risk of instability in the international monetary system. The decision of the IMF to include the RMB as an additional component of the SDR is a vote of confidence that provides an incentive for more central banks to hold RMB reserves, even if their willingness to do so will depend on further reform in China. Wider availability of another international currency, built upon what will become the world's biggest economy in the foreseeable future, could provide an alternative source of investment and an alternative store of value to the dominant dollar and ailing euro. Provided that the value of the RMB can be shown to be determined by the market, its wider availability in the international monetary system would be a factor of stability, providing more solid insurance against adverse developments in the two dominant world currencies, the dollar and the euro.

A more readily convertible RMB would also encourage two-way trade and investment between the EU and China. Abandoning a managed exchange rate for the RMB would reduce the risk of unfair competition in foreign markets, including the EU, from artificially priced exports from China. It would facilitate FDI in China that has been discouraged by currency controls. The opening up of China's financial markets would provide new opportunities for European financial service providers, including banks, brokers, insurance companies, and pension funds. In addition to these benefits for outsiders, a convertible RMB accompanied by the removal of interest rate controls would act as a boost for the Chinese economy, powered by the additional demand from domestic consumers who would obtain a better return on their savings than they do today. The likely rise in value of an RMB backed by an open Chinese economy

would improve the purchasing power of Chinese consumers of imported goods and services.

The EU would, however, have to come to terms with the adverse effects of the international rise of the RMB on some of its more narrowly defined interests. The RMB would become an alternative to the euro as a reserve currency and store of value, particularly if economic growth in China remained at levels higher than those in Europe and if Eurozone members were unable to overcome their policy differences. This might increase the risk of exchange rate volatility for the euro, currently mitigated by its role as the main alternative to the dollar as a reserve currency. Greater international recognition for the RMB would also weaken European influence in international financial institutions, the senior management of which has until recently been shared between the USA and Europe, with European candidates exercising a de facto monopoly over the post of Managing Director of the IMF, for example. This greater diversity would influence policymaking. Full liberalisation of the capital account in China would also increase the presence of Chinese investors in foreign markets, including the EU. An even faster rise of Chinese FDI in the EU would not necessarily be a negative development, as previously discussed in Chap. 5. But were Chinese investment in the EU to become much more widespread and financially significant, without a parallel opening of the currently closed sectors of the Chinese economy to European investment, there might well be more political pressure to reconsider the EU's so far open attitude to it.

## Conclusion

Policy change in the monetary area is traditionally cautious and well prepared. Given the political consequences for China of fully meeting the conditions required of a global currency, it will be even more cautious there. The Chinese leadership is still divided and may decide at some stage that the economic advantages of moving towards a convertible RMB are simply too risky in political terms. So far, progress towards that goal under President Xi's leadership has been steady, if unspectacular, and China has been rewarded for its efforts by the long-awaited IMF decision to include its currency in the SDR. This decision, combined with the long-delayed decision of the US Senate to recognise the IMF's 2010 revision of voting rules and continual commercial pressure to use the RMB more widely in international transactions, will work in China's favour, even if the key factors that will transform the RMB's prospects depend on domestic rather than international decisions.

Given its monetary diversity and internal policy differences, the EU is likely to remain an onlooker in this area of China's economic policy. It will nevertheless be affected by the emerging recognition of the RMB as a world currency. On the whole, the outcome should be beneficial for the European economy, but some in Europe will see the short-term costs of this transition, in terms of less visibility for Europeans in international institutions and greater competition between the euro and other reserve currencies, as carrying some risks.

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37. Guan Tao, 'Capital Flows Management: Lessons from International Experience', *IMF-PBoC Conference on Capital Flows Management* (Beijing, 20 March 2013). Guan, as Director-General, Balance of payments, SAFE, gives an overview of progress towards capital flows liberalisation (CFL) in China in the past four decades and the prospects for progress in the coming years. His (at times somewhat vague) prediction is that there will be a two-stage liberalisation process, similar to the liberalisation of the current account in the 1990s, with, first, liberalisation of most transactions "in a few years" and, second, liberalisation of remaining transactions two years later.
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CHAPTER 8

# Cooperation on Common Economic Challenges

*Key questions:*

- *How do China and the EU interact on policy issues of mutual interest?*
- *What are the practical and political limits to their cooperation?*
- *What is the EU interest in this process?*
- *Is this cooperation mutually beneficial or is it a one-way process that benefits China?*

The EU and China have a wide range of common interests, both economic and political, on which they seek to keep each other informed and influence each other's thinking through official contact and dialogue. No fewer than 68 EU–China policy dialogues were in place in early 2015, of which 50 came under the heading of "Economic and Sectorial Dialogues" (see Fig. 8.1). Although their objectives vary, these meetings usually provide an opportunity for exchange of information between the EU and Chinese sides about the goals and practical operation of individual policies, allow comparison and comment, and, in some cases, lead to an agreement on a joint work programme. The value of such work programmes is the main focus of this chapter.

The chapter will begin with a general overview of EU–China cooperation, indicating the range of policies covered by so-called Dialogues, the objectives of the process, its practical modalities, typical outputs, and the degree of political oversight. It will also situate these EU-level contacts with China in relation to the cooperation between China and the Member States.

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The second part of this chapter will consider four case studies of EU–China cooperation that address the broad issue of sustainability—environmental policy, climate change, energy policy, and urbanisation. These are salient policy areas that directly affect economic activity in both China and the EU. Governments on both sides have identified them as being amongst the most critical challenges facing their society, and are adopting ambitious policies to deal with them. The policy agendas of the EU and Chinese authorities are broadly comparable, reflecting the similarity of their situation as densely populated, highly industrialised but also resource-scarce regions of the world, concerned to slow down climate change, limit their dependence on external supply of energy and other resources, and improve the quality of life of their populations. In principle, a meeting of minds and a willingness to achieve synergies through cooperation should be possible. Yet the analysis will show that many years of EU–China cooperation have yielded limited results and few specific joint projects, despite such a promising background.

The concluding section of the chapter will assess the impact of EU–China cooperation in terms of information exchange, policy convergence, or the opening up of new economic opportunities in each other's market, and present a view on whether it is two-way and mutually beneficial or rather, despite repeated references by political leaders to a "win-win" situation, a one-way process that mainly benefits China.

## EU–China Policy Dialogues: How Do They Work?

Transparency of EU–China Dialogues is limited (it took the EEAS several months to draw up the information presented in Fig. 8.1). The analysis that follows is based partly on publicly available material but also interviews with several officials currently involved in the meetings, as well as private sector reactions to them. Most of these discussions are not reported on in publicly available documents, other than through press releases of meetings at the political level. Both sides would maintain that confidentiality is a precondition for a frank exchange of views and that greater transparency of these discussions might lead to more defensiveness. The other EU institutions (the Council of Ministers and European Parliament) have occasionally asked for more transparency but it remains limited.

As Fig. 8.1 shows, dialogue between the EU and China takes place at many levels and can mean many things. The EU–China Summits

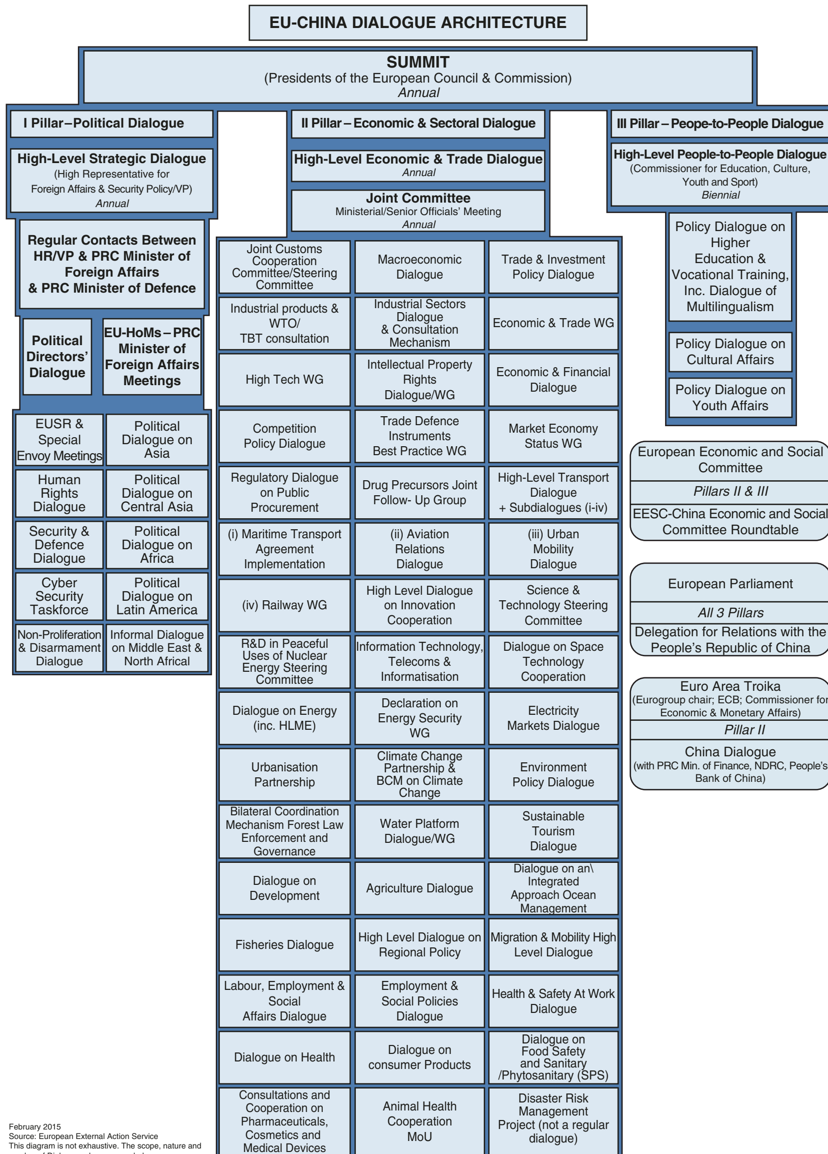


**Fig. 8.1** EU–China dialogue architecture. *Source*: EEAS, http://eeas.europa.eu/china/docs/eu_china_dialogues_en.pdf, accessed 19 December 2015

involve Heads of Government on the Chinese side and the Presidents of the European Council and Commission, as well as Ministers and Commissioners. The High-Level Dialogue meetings for each of the three main pillars of EU–China cooperation (political, economic and sectoral, people-to-people) involve European Commissioners and Chinese Ministers, as do some of the more important sectoral dialogues examined in the following section. More specific dialogues are steered by senior officials (Commission Director Generals or Chinese Vice-Ministers) or even middle management experts (Directors or Heads of Unit). The scope of the dialogue can vary from entire policy areas, such as competition, agriculture, energy, or health, to narrower subjects such as the management of drug precursors, electricity markets, or sustainable tourism. Some exchanges have been launched at the political level—at an EU–China Summit, for example—in order to give a higher profile or sense of urgency to the subject. Others reflect a more "bottom-up" approach, responding to a practical need for officials to keep in touch with each other's policy intentions. The latter discussions may also be related to international negotiations (on public procurement or climate change, for example) or the implementation of international or bilateral agreements (such as the Maritime Transport Agreement or a bilateral agreement on managing trade in drug precursors).

On the EU side, the Commission usually manages the dialogue process, except for the EU–China Summit meeting, which the European Council President co-chairs with the Commission President, and some specialised dialogues, such as the monetary policy dialogue, in which other bodies or institutions such as the Eurogroup and the ECB take the lead. Member States are not present, although in the case of more important meetings, the agenda may be discussed beforehand with the Council of Ministers, usually at committee level, and the same committee is debriefed afterwards. There have been efforts by the Council (in 2010–2011) to impose more regular consultation of the Council on this kind of external cooperation but the Commission maintained that managing this process forms part of its executive responsibilities and rejected the idea of permanent oversight. The European Parliament is not involved in these meetings but it may ask for information about them; it conducts its own discussions with the Chinese National People's Congress through its so-called Parliamentary Delegation to the PRC, a committee of interested Members of the European Parliament (MEP's).

Normally an agreement or joint declaration lays down the terms of reference of each Dialogue (examples are mentioned in the "Case Studies" section). However, the scope of the dialogue discussions is not always fully agreed: for example, in the competition policy dialogue, the Commission has tried without success to include discussion of state aid.[1] The discussions do not necessarily involve all the responsible agencies or Ministries; the responsibilities of the departments on each side do not always match, and it may be difficult to bring all of them to the table unless they have a direct interest in the outcome. Coordination between departments is not strong on either the EU or Chinese side. For example, the NDRC, the Ministry responsible for economic planning in China, is reluctant to engage in discussions with foreign officials unless it has an interest in obtaining information (for instance, about new forms of regulation or new technologies) and it usually avoids participation in dialogues, including those discussed in the following section.

The policy dialogue is often limited to an annual meeting, at which the two sides update each other on policy developments and offer opportunities for questions or comment. Whilst the broad scope of discussion may be defined there is often no specific goal, except to contribute to mutual understanding. The dialogue may provide a platform for raising concerns or identifying differences of approach (in respect of technical standards, for example, and the means of testing or ensuring compliance with them) but it does not always aim to resolve them. In most cases, there is no oversight of the discussions at the political level, no timetable for results, and no sense of urgency to make progress. The main goal is to develop mutual trust and familiarity with each other's system rather than to solve problems or bring about change.

In some policy areas, however, the two sides set practical objectives for their discussions and organise a programme of work to be pursued between meetings. Working groups of officials will discuss issues in more depth and report back to the plenary meeting. Examples include technical discussions on, say, standards in emerging technologies (such as electrical vehicles) or changes in customs procedures affecting trade.[2] Activities involving other parties, such as academic studies, workshops between researchers or technical experts, conferences involving the business community and other stakeholders, or training programmes may be agreed and funded.

The budgetary resources dedicated to EU–China discussions are significant. The climate change and energy cooperation dialogues, for instance, involve multiannual programmes of study and technical exchanges costing several million euros over a five-year period. The EU and China have

also established a Policy Dialogue Support Facility, with a multiannual budget of €5 million to support EU–China meetings and study contracts not funded elsewhere.[3] Estimating the overall cost of EU–China cooperation efforts is difficult. An estimate made in 2009 indicated that over €250 million was then planned to be invested by the EU in EU–China cooperation related to climate change, including projects related to energy policy, emissions trading, and the promotion of low-carbon technologies, as well as biodiversity.[4] The EU's investment in the same dialogues is as high today, and the total number of areas of cooperation has substantially increased since new areas of common interest such as urbanisation, agriculture or people-to-people dialogue have been included.

The Member States maintain their own contacts with China in many of the policy areas addressed in EU policy dialogues. These are matters of mixed competence, that is, where EU–level coordination or regulation may be accepted as necessary on some issues but where Member States remain free to conduct their own policy outside the areas in which the EU has chosen to act collectively. Member States develop their own relations with the Chinese administration in any area where they (or their business communities) have an interest in doing so, whilst exercising self-restraint in areas covered by EU–level discussions. National policy dialogues with China can range from the political level (Summit meetings involving heads of government and several ministers on each side have been organised in recent years by Germany, France, and the UK, for example) to the regular meetings between senior officials and technical-level cooperation between specialised institutions.[5]

In some cooperation programmes with China, including those discussed below, the EU has integrated Member States expertise into the EU's "offer" to China of policy discussion and technical assistance. Nevertheless, as in the case of research and innovation cooperation discussed in Chap. 6, the transparency of cooperation with China conducted by the Member States remains imperfect. Many countries prefer to maintain their own channels of access to the Chinese side rather than associate themselves with an EU initiative and share information that may have commercial or economic value. Whilst smaller Member States with fewer diplomatic resources tend to support EU–level coordination and information sharing, larger Member States consider that EU–level coordination brings little added value to their own efforts.

## Case Studies

Four case studies of EU–China policy dialogues may provide a useful illustration of how they operate in practice and how much they have achieved:

- The EU–China Environmental Policy Dialogue
- The EU–China Climate Change Partnership
- The EU–China Energy Dialogue
- The EU–China Urbanisation Partnership

These interconnected policy areas aim at a common goal of more sustainable economic development. They have been chosen for analysis because they are the ones where, at first sight, the prospects for closer EU–China cooperation are particularly promising, as the two regions are confronting similar challenges, albeit to different degrees.

China and the EU are both highly industrialised societies where the risks of adverse impact of economic activity on the environment and biodiversity are widespread and often severe, and addressing them has been given high political priority. The problem is particularly acute in China, where the economic costs of environmental damage have been calculated as equivalent to approximately 5 % of GDP.[6] Both are large-scale emitters of greenhouse gases that have recognised the threat of climate change and the need to put a ceiling on harmful emissions and establish market systems that reflect the costs of carbon. Both are important users of fossil fuels (China alone accounts for half of the world's coal consumption),[7] are highly dependent on imports of energy resources,[8] and are committed to greater use of renewable energy systems and to energy saving, in order to increase their energy security, as well as reduce pollution and mitigate climate change. Both are concerned with the problem of ensuring urban sustainability, although China, where the level of urbanisation will continue to grow rapidly from its current level of 54 % to 70 % (slightly less than the current EU level) by 2030, is facing the bigger challenge. [9] Cities are the dominant core of the modern economy, and economic sustainability depends on their more integrated management.

Both China and the EU have in the past decade reinforced their political commitment to sustainable economies. Sustainable development is set out in Article 3(3) (TEU) as an overarching and long-term goal of the EU, which must be taken into account in all its policies. The Chinese

leadership committed itself at the Third Plenum to building an "ecological civilisation" in China, a concept first presented by President Hu in 2007, as a key element of its economic reform programme.[10] Less pollution and a healthier life is as much part of the "Grand Bargain" between the CCP and the Chinese people as the offer of material prosperity.

In many of these policy areas, the EU and its Member States have pioneered measures designed to address the problem of sustainability and European firms have developed the technical solutions necessary to support them. Examples include the Climate and Energy package agreed in 2010, whereby the EU agreed to reduce its carbon dioxide ($CO_2$) emissions and increase the share of renewable energy sources in its energy mix by 2020, the introduction of an emissions trading system, as well as EU legislation on restricting air and water pollution, environmental standards for industrial products, and recycling.[11] While these measures have not all been successful (the EU emissions trading system has suffered, for example, from not achieving a high enough price for carbon through early over-supply of emission permits), the EU has clearly put sustainability at the centre of its industrial policy and has experience of implementing the complex systems designed to achieve it, whether technological, regulatory, or market-based, that China is interested in acquiring or at least studying.

The EU also has compelling reasons to encourage China to address its sustainability challenges. First, China's importance as an emitter of carbon (responsible for 29 % of global emissions in 2012) or as a consumer of fossil fuels and raw materials is so great that its behaviour affects global environmental and economic outcomes and imposes costs on the rest of the planet.[12] Improving China's performance in terms of sustainability would make a major contribution to slowing down climate change and reducing pressure on the world's natural resources. Second, China's shift towards more sustainable economic policies opens up opportunities for the EU, in terms of providing advice, analysis, research, technology, management systems, or financial engineering, that could represent a source of mutually advantageous business opportunities. Third, Europe, too, is on a learning curve; this is not a case of a strong partner being in a position to exploit a weaker, or a dominant supplier monopolising a technology. China has already developed the industrial and technical capacity to compete internationally in such areas as alternative energy supply, and it is mobilising significant financial resources for research and innovation in other areas. Both sides in the partnership face challenges and neither has all the answers. The dialogue could, therefore, be a partnership between highly motivated equals.

The case studies that follow will present the dialogue's legal or political framework, its objectives and content, and its outcomes in terms of policy convergence or the development of joint research or economic activity. They will also highlight the obstacles to success.

### *Environmental Policy Dialogue*

This dialogue began at working level as long ago as 1992 and was upgraded to ministerial level in 2003. It is managed by DG Environment in the Commission and the Chinese Ministry of Environmental Protection. Its scope is ambitious. At the ministerial meeting in July 2013 (the fifth in the series), the EU and Chinese sides agreed to cooperate in the framework of multilateral environmental agreements on biodiversity, chemicals, and waste management, to work on the promotion of more sustainable production and consumption, to cooperate in the other side's flagship initiatives on the environment, and to exchange experience of addressing air pollution in urban areas.[13]

The Commission also proposed to establish an Environment Forum to address topics of mutual interest, which would involve business and other stakeholders, with a first meeting in 2014 to discuss Green Growth. The Chinese side was non-committal, only agreeing to study the feasibility of such a Forum, which did not in the end take place. This episode illustrates a common problem in all EU–China dialogues, namely, the reluctance on the Chinese side to agree to direct contact and collaboration between non-state actors. On the EU side, the business community and civil society are seen as essential partners in improving sustainability and they are encouraged to take on more responsibility for it; on the Chinese side, by contrast, the concept of bottom-up policy development is not only unfamiliar, it is often seen as a threat to the political order.

Three cooperation programmes have been launched under the Environmental Policy Dialogue. The EU–China Environmental Governance Programme (2011–2015) is intended to help the Chinese authorities improve the governance and practical management of environmental policy in China, which is politically sensitive as environmental disasters have given rise to popular unrest and occasionally violent protest. The programme focuses on access to environmental information, public participation in consultation and decision-making, access to justice on environmental issues, and the engagement of the private sector in sustainable practices, all of which are challenging for the Chinese side given the Chinese tradition of top-down and often secretive decision-making.

The programme carries out joint studies that examine Chinese environmental legislation and how it is applied at the provincial level and make recommendations for improvement. A consortium of European and Chinese experts, with the Chinese Academy for Environmental Planning as lead partner, conducts the studies. Illustrations of the working method and the robust character of some reports can be seen in two of them made in 2013: "Policies and Practice of Corporate Environmental Information Disclosure in China," based on practice in Zhejiang and Shanxi provinces, and "Weaknesses of Public Participation in the Environmental Impact Assessment Process in China," based on practice in Shandong and Yunnan provinces.[14] Considering that China is a one-party state, these reports are remarkably outspoken about the shortcomings of the current system, in terms of, for example, lack of transparency of rule-making, inadequate opportunity for public comment, inadequate penalties for non-compliance or the absence of inspectorates. No information is available, however, on whether the recommendations of the reports have been acted on by provincial authorities.

The EU–China Environmental Sustainability Programme addresses pollution issues (water pollution, heavy metals pollution, and solid waste management) as well as more general issues such as policy integration and information disclosure. A first set of studies on these issues was made in 2013. There is no information as to results, and no overall assessment of progress, although individual projects (such as, for example, a water management project to improve water quality and the treatment of polluted water in the Tianjin–Bihai New Area) post reports on the internet.[15]

The China–EU Water Platform (CEWP) is a €25 million programme intended to achieve an integrated approach to water management in China, where water is relatively scarce (with 20 % of the world's population, China only has 7 % of its fresh water supply)[16] and much of it is heavily polluted, with analysis by the World Bank in 2012 showing that 40% of China's rivers fall into the two worst water quality categories (Grade V and V+) whose direct use "would endanger health."[17] A Joint Statement announcing the CEWP's creation in 2012 emphasised that the programme aimed at encouraging capacity-building and technical and business cooperation, as "a partnership among equal partners."[18] The added value of the platform would come through information exchange, cooperation on testing new technologies in China and Europe, facilitation of mutual access to cooperation in the water sector, and creation of a

platform for research and a bridge for business groups to jointly develop and implement concrete solutions for specific projects.

Information exchange has been launched in four priority areas (rural water and food security, water and urbanisation, water and energy security, water management and ecological security). A striking feature of the programme is that it is a joint effort of the EU and its Member States, coordinated by Denmark with ten Member States taking the lead on specific projects because of their particular expertise. Thus, Spain leads on discussion of irrigation issues, the Netherlands on flood management, Austria on small-scale hydropower, and France on river basin management, with Finland, Denmark, Sweden, the UK, and Portugal acting as leaders of other projects. The programme aims to develop innovative demonstration projects in nine "co-lead" project areas.[19] So far, however, the programme has not led to cooperation between European and Chinese companies. In 2014, a report for the CEWP Business Pillar, set up under the programme to foster EU–China business links, pointed out the slow start in involving EU businesses in water projects in China, mainly because of difficulties in obtaining information from the members of the Chinese Water Enterprises Association and the lack of financial support from either the EU or China for promotion of business-to-business contacts.[20] From the business side, at least, there appears to be a gap between the declared commitment to greater business links and its delivery.

One explanation of the disappointing performance of EU–China cooperation in the environmental policy area, and perhaps others, is the lack of human resources to manage them. A Commission official interviewed in 2014 said that there was enough work concerning China to occupy two or three officials full-time, but that only one official was available part-time.[21] Another, dealing with the EU–China climate change dialogue, mentioned that a Chinese proposal to include management of fluorinated gases to the joint work programme could not be taken up because of lack of Commission staff. Subcontracting the management task to non-governmental bodies (or to national administrations, as in the CEWP case) is an option, but that can lead to different management practices and levels of transparency, lack of consistency in pursuing the programme, and a risk of confusion on the Chinese side (where such tasks would not be delegated) about the EU's commitment to the dialogue. Indications of the Chinese level of funding and manpower in the programmes are not publicly available.

### *Climate Change Partnership*

China is central to international discussions about climate change. It is important both as the biggest emitter of greenhouse gases, whose emission levels per capita overtook those of the EU in 2014, and as a developing country that strongly advocates differential treatment in any future international rules on managing climate change.[22]

The EU and China agreed in 2005 to form a Climate Change Partnership to strengthen their dialogue on climate change policy, exchange views on international climate change negotiations, and encourage low-carbon technology development and uptake. One major objective of this Partnership was the development and demonstration of advanced, "zero emissions" coal technology based on $CO_2$ capture and geological storage. Another was the promotion of other clean energy sources, as well as energy efficiency, energy conservation, and renewable energy.[23] Relations between the two sides on climate change policy have not always been easy, especially following the vociferous Chinese opposition to new international disciplines at the Copenhagen United Nations Framework Convention on Climate Change (UNFCCC) Summit in 2009, but policy differences do not seem to have affected their intention to work together at the technical level. Indeed, even at the policy level, they were able to agree a joint statement on Climate change in June 2015 which looked forward to an ambitious outcome for the COP 21 negotiations in Paris in December 2015, with the Final Agreement reached broadly reflecting this optimism, albeit after tough negotiations.[24]

The work plan established under this partnership covers all areas of climate change policy and many that overlap with other dialogues. Priorities include, for example, several energy policy matters, such as energy efficiency, renewable energies, and a major project to demonstrate near-zero emissions coal technology in China and the EU through carbon capture and storage, which are discussed in the next section. The EU and China are also exchanging know-how on emissions trading systems, through regular contacts between officials. The EU is represented in the steering body overseeing the trials in several Chinese cities of carbon emission trading systems that have been going on since 2012.[25]

One of the main instruments for implementing this Partnership is the EU–China Low Carbon Economy Platform, which brings together the European Commission, the Member States, and a number of interested international organisations at regular intervals to coordinate their work in

support of China. The Platform has set up a website which provides a means of information exchange in English and Chinese on emerging technology and regulatory practice in the EU and China, as well as relevant multilateral bodies, such as the International Energy Agency. It organises conferences and workshops and circulates studies on technological developments and regulatory practice across fields such as renewable energy, clean coal, smart grids, energy efficiency, green buildings, e-mobility, and carbon markets.[26]

Apart from announcements and short reports on the website of the Low Carbon Economy Platform, however, there is no publicly available information on the Partnership and no overall assessment of its progress. This silence can be taken in one of two ways: either there is a lot going on but everyone is too busy to report on it, or there is very little going on but no one wants to admit it. Another explanation may be unclear lines of responsibility within the Commission: climate change policy is managed by one department (DG Climate Action) whilst many of the technical areas for discussion with China have until now been managed by another (DG Energy). The Commission decision in early 2015 to make DG Climate Action responsible for managing energy-related projects relating to climate change may lead to a more coherent overall view in future but none is visible at the time of writing.

### *Energy Dialogue*

First contacts on energy policy between the EU and China were made as early as 1994 and a Memorandum of Understanding was concluded in 2005, in which six priority areas were identified for cooperation: renewable energy, smart grids, energy efficiency in the building sector, clean coal, nuclear energy, and energy law. The list clearly indicates a focus on sustainability, efficiency, and safety in the energy sector.

Since 2012, the guideline for this work has been the EU–China Joint Declaration on Energy Security, made in 2012 by the then Energy Commissioner, Guenter Oettinger, and the Head of the Chinese National Energy Administration, Liu Tienan. The goals of the Declaration are ambitious, focusing on the convergence of EU and Chinese interests across a wide range of issues, from more open, transparent, and competitive energy markets and rules-based energy governance at the global level to technical standards for nuclear safety, the development of low-carbon urban energy systems, and the compliance of off-shore oil and gas production with safety, health, and environmental standards.[27]

From discussions with Commission officials, however, it appears that the Joint Declaration has not led to much cooperation. In part, this is because the EU has been concentrating on energy problems in its immediate neighbourhood, particularly following the Ukraine crisis, and the challenge of assuring gas supplies from Russia.[28] Commission officials hope that more long-term thinking in the EU will emerge from discussion of proposals for an Energy Union within the EU, launched by the Commission in March 2015, and that this will also be conducive to closer energy cooperation with China. The Commission has drawn up a "roadmap" for cooperation focusing on priorities common to both sides, such as renewable energy, energy efficiency, and the reduction of dependence on external energy supply; but although mentioned as a common interest at the June 2015 EU–China Summit, the roadmap has still not been agreed.[29]

Commission officials suggest that there may be a mismatch of EU and Chinese objectives in this dialogue. Whilst the EU is aiming at partnership on alternative and sustainable energy supply, with opportunities in China for EU companies offering the technology and skills that China wants, China is more interested in developing physical connection of power supply between China and Europe, a much lower priority for EU. The two sides may also have competing interests in terms of securing external supply of energy, as both of them see Central Asia becoming a more important supplier of fossil fuels. The energy dialogue roadmap may help to clarify some of these differences but it may paper over others.[30]

Meanwhile, two cooperation projects have received funding from the EU side.

- The EU–China Clean Energy Centre in Beijing, usually referred to as EC2, was launched in 2010 as a five-year platform to encourage increased use of clean energy in China, by setting up cooperation projects between EU and Chinese enterprises, with an EU financial contribution of €10 million. It is managed by a consortium of European and Chinese partners which has set up a database of clean energy technologies to help exchange knowledge, prepared advisory reports on clean energy policies, organised seminars, training courses, and study tours, and sought to raise awareness in China of the benefits of clean energy through promotional campaigns. However, there is no indication that the programme has actually led to any joint projects involving business interests.[31]

- The EU has also made a financial contribution of €15 million to the International Institute for Clean and Renewable Energy (ICARE) in Wuhan, deciding in May 2015 to extend funding by a further 30 months.[32]

As in other cases, there is a certain frustration on the EU side that, the energy dialogue is largely restricted to officials rather than engaging technical experts and researchers, on the one hand, and companies on the other. The EU Chamber of Commerce in China has repeatedly complained about the difficulty of finding and then working with Chinese partners in this sector, which is largely state-controlled.[33] Commission officials, on the other hand, have made the point that Chinese interests are and will remain the main driver of energy cooperation, and that Chinese priorities will determine its direction.[34]

### *Sustainable Urbanisation Partnership*

Cities are home to three-quarters of the population of developed countries, and to over half that of China, and are now widely recognised as drivers of economic growth. The EU–China Sustainable Urbanisation Partnership, inaugurated in 2012 at the EU–China Summit, reflects the importance of urban culture, and the need to influence it in both Europe and China. The Joint Declaration called on

> governments and businesses on both sides to provide financial, technical, and personnel support for related initiatives and promote multi-faceted exchanges and cooperation.[35]

A press communication at the time declared that the partnership

> will offer a natural framework for concerted actions, such as a new programme designed to assist Chinese mayors, and the creation of an annual EU–China Urban Forum. The political initiative should also constitute a platform for Member States to leverage their existing and future actions in the field of urbanisation in China.[36]

This Partnership aims to organise projects and meetings to exchange experience, such as the EU–China Urban Forum, which involves local government representatives from both sides. Under its umbrella, 12

European cities were identified in 2013 as having concluded sustainable urbanisation cooperation agreements with their counterparts in China.

According to Commission officials, however, the content of these programmes is not yet fixed, even if occasional exchange visits between municipal officials have taken place.[37] Organisational problems have got in the way of cooperation: top-down decision-making in the Chinese administration leads to long waiting periods before agreement. Lack of cooperation between (and sometimes within) different Chinese ministries can also be a difficulty, given that bringing together different areas of competence is essential to the process. Chinese Ministries have so far focussed on promoting their own sectorial programmes and area of competence (such as energy, housing, communications technology, or environmental protection) rather than looking for cross-cutting solutions to broader problems in cities. A striking example of the degree of independence of the Chinese bureaucracy was the decision of the NDRC, designated as the coordinating Ministry for this initiative, not to attend the first meeting of the Forum in 2012, notwithstanding its endorsement by the then Vice President Li Keqiang.[38] Furthermore, as in other dialogues, lack of progress has also been attributed to the fact that the Commission and Chinese bureaucracies do not have the staff to work on it.

Management of inter-city cooperation has been conferred on EC-LINK, a China-based organisation set up in 2013. The network has made a slow start, allegedly because of delays on the Chinese side attributed by EC-LINK to lack of interest by the NDRC. A first conference of the network took place in July 2015, a full two years after its launch, and, whilst the organisers hope that this will accelerate the cooperation process, there is little evidence so far of concrete projects.[39]

EU–China cooperation in this area also includes the EU–China Smart Cities dialogue, managed since 2012 by the Chinese Ministry for Industry and Information Technology and the Commission's DG for Information and Communications Technology, which focuses on making best use of information and communications technologies to supply more interactive and efficient infrastructure and services for cities in the areas of administration, education, healthcare, public safety, real estate, transportation, and utilities.

The EU–China Sustainable Urbanisation Partnership, then, like the others examined here, has not properly taken off. Discussion is intermittent, conducted largely at the political level, and has not been taken up in a substantial or self-sustaining way by the cities identified two years ago as partners. Research or business partnerships appear to be even further down the track.

## What Difference Do the EU–China Dialogues Make?

What do these case studies tell us about the impact of EU–China dialogues so far, and the economic relevance of the EU's contacts with China? To answer that question, one might consider the performance of the dialogues against the most frequently mentioned objectives of the Memorandums of Understanding or Joint Declarations that have set them up: the improvement of information exchange, mutual learning on policy issues, and opportunities for economic partnership.

On improvement of information exchange, the programmes seem to score relatively high. They have all instituted a process of regular exchanges between officials, sometimes but not always extending to other interested parties. They have in many cases established technical structures which ensure that information exchange can occur at a more detailed level between experts (such as in the CEWP or the EU–China Clean Energy Centre, for example) and funded databases that are able to diffuse knowledge, usually in English and Chinese, to a wider audience. A striking example of new provision of information is the Environmental Sustainability Programme of studies on governance in China's environmental policy, which has highlighted deficiencies in both regulation and its implementation in Chinese provinces. How far these critical studies are made available to a wider audience is uncertain, but the fact that they have been carried out at all indicates openness to change within parts of the Chinese government.

In general, however, the exchanges are limited to government officials at central or occasionally local level. Cooperation sometimes includes the research community, with some of the programmes organising meetings of researchers on particular topics,[40] but only rarely businesses,[41] and when it does, the results have been judged insufficient by the European side. The main reaction from the European business community so far to the promise of closer cooperation with China on sustainability challenges appears to be disappointment, even if officials say that it is too early to judge.

In terms of the influence of EU–China cooperation on policy thinking, the picture is rather mixed. There is some evidence of China taking up European methodologies or standards in the environmental or climate change area. China has chosen to follow European car emission standards as they have been developed over the past two decades, for example, and is experimenting with various forms of $CO_2$ emission trading system inspired

by, if not exactly modelled on, the EU system. This might imply a degree of trust on the Chinese side in Europe's expertise. China's approach, however, is selective and often non-committal: it is ready to try many technical options without being wedded to a single source of ideas. Nevertheless, there are examples of the EU being solicited by the Chinese side to broaden cooperation to new areas of interest to China, such as air pollution, food safety, or new threats to global warming, for example, which seems to suggest that the potential for influence is there, even if the EU is often unable to respond because of lack of resources, both financial and human. This is a reminder that not all the gaps in cooperation can be laid at the door of China.

Influence on policy, if it exists at all, is one-way, from the EU to China. Although the urbanisation or energy programmes speak of two-way learning and mutual benefit, there has been little evidence of either. The EU has been the dominant investor in a process that remains essentially a technical assistance programme, even if funding mechanisms on the EU side now put more emphasis on the need for EU–funded cooperation to provide benefit to the EU itself.

The benefits of EU–China cooperation for the real economy, either in terms of creating opportunities for companies of either side to operate in the market of the other, or of introducing technologies and know-how that improve the performance of the other economy, appear to be very limited. The joint projects or experimental technical platforms promised in a number of the case studies are still at the drawing board stage, even after several years, and there is anecdotal evidence of reluctance in key parts of the Chinese administration, such as the NDRC, to take the process further, perhaps because it would open up promising markets to foreign competition and would undermine the somewhat nationalistic, "not invented here" view of innovation that still prevails in parts of the Chinese administration. In the areas of cooperation of greatest interest to European companies, such as power generation, transport or water management, their Chinese counterparts are state-owned and operate in sectors largely closed to foreign investment. European companies based in China have recently complained about how Chinese regulations on technical standards, government procurement, and investment prevent them from participating in sustainable urbanisation projects.[42] The relatively tightly controlled Chinese system, in other words, does not lend itself to voluntary and opportunistic cooperation between commercial partners that European companies may be used to in other

markets, such as the USA, for example. This may change over time, but the language of the Third Plenum decisions and the objectives behind President Xi's "China Dream" seem to suggest that opening up these markets will be slow.

## The EU or Its Member States as China's Partner?

Both the Union and its Member States are investing in cooperation and dialogue with China. There is a strong motivation to do so, not only in terms of influencing the course of the world's second biggest and soon to be biggest economy, whose policy choices will affect the rest of the world, but also because of the potential opportunity for management and technological partnership with China for research institutes, technical service providers, or manufacturing companies.

In some cases, such as the CEWP, the EU has succeeded in bringing together the efforts of its Member States, playing to the strengths of each, and has delegated the management of the EU programme to one of them, Denmark. In others, the relationship between the work of the EU and its Member States, particularly the bigger ones, is harder to see and there may be a degree of overlap. But this is neither surprising, given the size of the Chinese market, nor unwelcome, given the scale of the sustainability challenges to be overcome in China: there is more than enough work for everyone. Intra-EU coordination may be loose and local (it is carried out largely by the EU Delegation and the Counsellors of the Member State embassies in Beijing) but it does exist.[43]

## Conclusion

This analysis suggests that, despite the existence of common interests and the ambitious goals that have been set at the political level, EU–China cooperation has yet to deliver mutually advantageous results. The absence of information about cooperation on identifiable joint projects several years after their launch suggests at best an unfavourable environment, at worst political reservations on the Chinese side.

Cooperation has taken much longer to get started than anticipated, even in areas where at the political level everyone appears to subscribe to the urgent need to address common problems. This may be due to lack of resources and overwork in both bureaucracies but, on the Chinese side, it is also a result of waiting for approval from the political level, which is

slow in coming. Some ministries such as the NDRC appear to be indifferent to international cooperation or, more precisely, concerned to prevent cooperation in the form that China prefers, such as information exchange, from developing into mutually beneficial economic opportunities, which China may want less. From the latest report of European Union Chamber of Commerce in China, representing European businesses based in China, one can detect a concern that the Chinese government is reserving new economic opportunities for Chinese actors and postponing changes in the rules governing the Chinese economy that would encourage wider participation in cooperative ventures.[44]

EU–China cooperation is, therefore, a largely one-way process of technical assistance from Europe to China. This is a perfectly laudable objective. If, however, the growth of Chinese technical and financial capabilities leads to a stronger flow of Chinese investment into European sustainability projects before China allows a larger European presence in comparable projects in China, this disparity of treatment could be a new cause of friction between the two sides.

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# PART III

# The Importance of EU–China Economic Relations in the Coming Decade

CHAPTER 9

# The Elephant in the Room: The Role of the USA in EU–China Relations

*Key Questions:*

- *How and why are differing Member State attitudes towards China affecting the Atlantic Alliance?*
- *What impact is China's regional power having on EU relations in East and South East Asia?*
- *Why does China view the United States as a constant "elephant in the room" in its relations with the EU?*

The chapters of Part II have examined the EU's bilateral economic relations with China in some depth. It is difficult, however, to draw conclusions about the EU–China relationship in isolation from the relationship that both parties have with the USA, a major economic partner of both China and the EU and the closest political partner of the EU. This chapter will analyse the influence of the USA on EU attitudes to China and explore how the growing economic links between China and the EU are beginning to change some European countries' response to the USA.

The role of the USA intersects the relationship between the EU and China at the global level in a number of major ways.[1] How has this triangular dimension affected China's relationship with the EU? The role of the USA in shaping European foreign policy thinking in general and the EU's bilateral relations with China in particular is an ever-present issue of significance. The longstanding links that the USA enjoys both with the EU as an institutional entity and with individual Member States of the Union reflect

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America's role as global hegemon and principal architect of the post–World War II global order. However, the comprehensive and distinctive relationship that the USA maintains with the EU is in juxtaposition to equally complex links that each party has with China. This contemporary nexus of power relations needs to be explored and parts of it individually addressed in order to make sense of the whole.

This chapter will analyse how these triangular factors are shaping EU–China relations, focussing on four different but interconnected dimensions: first, the emergence of differing Member State attitudes towards the USA caused by closer national-level relations with China; second, examining how US influence reaches into the bilateral relationship of the EU as an independent actor with China; third, examining how the EU's endeavours to build relationships across East and South East Asia are being undermined by the re-emergence of China as a major power, the continuing dominance of the USA as the region's principal security actor, and the absence of a coherent EU engagement strategy; and fourth, assessing how far the US role as global hegemon is under threat from the development of EU–China relations.

The conclusions of this chapter paint a picture of a dysfunctional EU, faced with internal divisions over how best to square incompatible positions at Member State level between support for the USA, on the one hand, and engagement with China, on the other, coupled with an underdeveloped regional strategy for Asia that has yet to come to terms with the hedging strategies of Asian states in response to China's economic power and renewed assertiveness. The effectiveness of the EU's responses across the region is found to be diminishing, in terms of political coherence as well as direct economic influence. In this context, the European Commission's Review of Global Strategy for Foreign and Security Policy announced for 2016 will be an opportunity for the EU to reflect on strategic priorities and tactical options in order to continue to play a meaningful role as a major regional power in a world of "variable geometry."[2]

## Fracturing Member State Attitudes

The politics of the EU's economic relationship with China is not simply a matter for the European institutions in Brussels, notwithstanding formal EU competence under the European treaties. Instead, policy issues and different positions on them permeate between Brussels and Member State capitals, as each national economy attempts to calibrate a response to the

economic impact of China's re-emergence. Whilst the most important external economic relationship for the EU as a whole continues to be with the USA, the inevitable continuation of this situation into the future may need to be reconsidered. China has now become a key trading partner for many Member States and bilateral relations with the People's Republic has become a consideration that weighs on politicians in some capitals with the same salience as relations with the USA, if not occasionally greater. China is considered now to be a strategic partner whose demand for EU goods, potential as a consumer of European business services, and outward investment appetite for European technology and corporate assets are set to grow at a healthy pace, offering EU Member States incentives to develop their own engagement strategy for China, irrespective of the policy preferences of Washington, DC.

These characteristics are likely to become ever more significant as Europe's bruised economies emerge from recession. Tension may grow between the economically more efficient and knowledge-led Member States, which broadly see China positively as a market for exports and a source of inward FDI, and those Member States where trade with China mainly represents a threat to their own domestic industries. Those governments that can capitalise on their competitive advantage against the Chinese will wish to take account of the fact that China has been rapidly increasing its economic linkages with Europe in recent years, doubling its share of total EU exports since 2002 at the same time as the USA share has been recording "a significant and continuous fall."[3]

Seen in this light, the apparently technical and yet also highly political issue of whether and when the EU should grant MES to China is symbolic of a deeper divergence of attitude amongst the Member States towards the Chinese economy. Some European economies are more than ready to overlook those characteristics of China's economic model, such as dumping and the use of subsidies, which official opinion in the corridors of DG Trade and the Office of the United States Trade Representative has long considered unacceptable.[4] Of course, demands for reviews of Chinese export pricing from threatened EU businesses in distressed economic areas will continue, regardless of when MES is granted to China. Indeed, the implementation of TDIs is not dependent on whether the exporting country enjoys recognition as a market economy—this mainly drives the technicalities of input pricing calculations—but it is anticipated that the continuing application by the EU of extensive anti-dumping measures, such as those which have been used against China in the past, would

become more difficult to sustain once China is granted MES. Future calls for continuing vigour in the application of TDIs by the EU are therefore increasingly likely to face arguments in favour of building bridges with China from those Member States whose current and future economic success is now heavily connected to trade with and investment from China.[5]

Germany is perhaps the most significant example of this phenomenon. A distinctive China perspective has emerged in the Federal Republic's foreign and economic policy in a strategy that has been termed "a technology-for-markets swap."[6] The German economy had a trade-to-GDP ratio of 70 % in 2014, and the German Federal Statistics Office ranking of partners in foreign trade clearly shows the significance that China now holds, with Germany's total trade turnover with the People's Republic (exports plus imports) amounting to €154 billion that year, placing China third overall, ahead of the USA and UK and only just bettered by Germany's immediate neighbours, France and the Netherlands.[7] In the wider context of German international relations, whilst it is certainly too soon to speak of China eroding the political stature of the transatlantic alliance in Berlin, economic reality such as this must raise the question as to whether Germany may not in future take a more balanced approach in its relations with both China and the USA than in previous decades.[8]

The UK's recent strengthening of economic ties with the People's Republic adds further complexity to the network of EU Member State relationships with China. The UK's position is rather different to that of Germany, in that its ambitions for closer trade and business ties are currently well ahead of its achievements. At the end of 2014, the UK still traded more goods and services with traditional partners, such as the USA, France, and Germany, than with China, which is Britain's sixth largest export market. However, since 2015, the British government has identified the strengthening of its links with China as a strategic priority, aiming to create what a senior minister has suggested could be a "golden decade" for both countries as Britain seeks to make China the country's second largest trading partner and, more pointedly, to become China's "best partner in the West."[9] These twin objectives have implications for both UK and EU strategy in regard to China.

Despite the positive rhetoric, the UK's trade and investment interconnections with China are currently less developed than they could be, for a number of reasons. First, trade between the UK and China in goods and services is not at first sight particularly well-aligned to the fastest-growing Chinese domestic markets, whilst the UK's specialisation in advanced

financial, banking, and insurance services coincides with sectors in China that are highly protected, where state-owned enterprises predominate, and where the possibility of China offering reciprocity of market access continues to be politically controversial.[10] Second, even if one assumes more proactive reform of China's domestic economy, it is difficult to find evidence that the CCP would be willing to alter market access conditions in these sectors radically, just to favour the UK. Indeed, this is a problem not just faced by the British but by the EU as a whole.[11] To realise its ambitions, Britain needs to persuade China both of its seriousness of intent to build bridges between the two nations and of the benefits that could materialise once such links are well established.

This may help to explain why cooperation between China and the UK has been strengthening in a number of high-profile areas. For example, in respect to British infrastructure projects, whether in nuclear energy or high-speed railways, these offer the Chinese much-needed and highly valued opportunities for investing their surplus foreign reserve holdings to gain stable long-term returns whilst simultaneously providing much-needed additional sources of funding to the UK. Few other countries in the OECD, let alone the EU, would be prepared to offer such entry into capital projects of national significance as the British are offering to China. This makes opportunities such as these a unique selling point on which the Sino-British relationship could develop momentum into the future.

Yet, such overtures by Britain may carry risks. Reactions to its overtly positive engagement with China have ranged from concern to bewilderment. Some have characterised UK policy as "a pure mercantilist, unprincipled, self-serving decision," whilst others have pointed out that such an approach could be counter-productive in the long term.[12] The extent to which closer bilateral ties to China could call into doubt Britain's dependability as an ally of the USA in security and geopolitical terms remains an implicit question beneath the surface of such criticisms.[13] Such views may also reflect concerns that UK foreign policy in respect to China shows signs of having been captured by the financial experts of the Treasury rather than being led by the regional experts of the Foreign and Commonwealth Office.[14]

For the USA, any strategic pivot towards accommodation of Beijing by the UK is likely to raise anxieties over the extent to which its traditional and most dependable European ally could be relied upon in future for diplomatic, intelligence, and military support for putative US-led initiatives to intervene in maritime conflicts between China and other East Asian powers

over island sovereignty in the East and South China Seas. For the EU, the prospect of both the UK and Germany—two of its most significant Member States—unilaterally pursuing closer strategic links with China raises questions of policy coherence on a range of issues that are to be decided by the EU acting as a whole, most imminently including the recognition or not of MES for china and securing a Bilateral Investment Treaty.

Broad alignment between the USA and the EU in dealing with China at the policy level is, of course, still a perfectly plausible scenario, but sustaining full convergence in all policy areas and across all Member States in their relations with the USA does appear to have become much more difficult when balanced against individual national priorities over links with the Chinese. Solidarity has already come under strain in respect to the role of individual EU Member States in the China-inspired AIIB, where strongly voiced American hostility was ignored by more than one key European economy. Such divergence is unlikely to be an isolated instance. Against this more nuanced background to EU–US relations, it is not inconceivable that a future outbreak of military hostilities which involved the USA and China in a direct confrontation in, for example, the South China Sea, could threaten to fracture EU Member State responses, as each would need to carefully weigh the cost of offending a key trade partner, China, against the benefit of supporting its traditional security partner, the USA. Such a dichotomy could significantly raise political pressure within those EU countries which are members of the UN Security Council at the time (permanent or otherwise) and whose global security commitment might be less at the forefront of their foreign policy thinking than their successful economic partnership with China.

## The US Dimension in the Union's Bilateral Relationship with China

The role of the USA also creates a complex triangulation in the evolution of EU–China relations at the level of the Union. Part of the problem lies in the structure of Union decision-making in foreign policy that is a shared competence with Member States. Despite the investment in manpower and organisational visibility of the EEAS as an EU diplomatic corps, national capitals effectively compete with Brussels for visibility in achieving policy-specific outcomes that are often crafted to benefit individual economies rather than the Union as a whole. In particular, China has a reputation

for prioritising dialogue with the Beijing embassy of key bilateral Member State partners over Union delegation dialogue in an illustration of what has been characterised as a rediscovery of the intergovernmental over the supranational. For example, German diplomats appear to be invited to far more private policy briefings and political dialogue meetings than other Europeans, including the EU Delegation itself.[15]

At least part of this complexity lies in China's oft-stated expectation of what the EU as a meaningful actor could have delivered as a distinctive pole of authority in the post–Cold War arrangement. This outlook on power distribution provided the foundation for China's moves towards strengthening its relationship with the EU at a strategic level in the early 2000s. Chinese policymakers saw this as a way to construct a different systemic architecture, their objective being to achieve greater power balance at the global level as an effective support to their own country's re-emergence.[16]

Evidence suggests that, in China's view at least, the EU has failed to meet these expectations. An examination of the tone and emphasis of China's two strategic policy papers concerning its relations with the EU, one published in 2003 and the second in 2014, illustrates this frustration.[17] In the first paper, there are clear signs of optimism about the important role that the EU can play in the deepening multipolar world, in which China is assuming a more active role whilst still feeling its way.[18] By contrast, the tone of the 2014 paper shows a resurgent and self-confident China outlining its own place within the global sphere, drawing conclusions about the challenges facing the EU since the global financial crisis, and calling on Europe to work with China in order to "pursue peaceful development in a multi-polar world, … make the international order and international system more just and equitable, … and set an example of different civilizations seeking harmony without uniformity."[19]

On the last point in particular, China continues to be perturbed by the direct leverage that the USA is perceived to have on EU decision-making. Chinese concerns over the future global role of the EU are deep-rooted and stem from more than recognition of the EU's current structural or financial weaknesses. From the vantage point of Beijing, Europe's views on the shape of global governance and the prospects for what the Chinese regard as the future democratisation of international relations, through improved recognition for states such as China in terms of votes, quotas, and leadership within existing international institutions, are underpinned by one key

factor—the transatlantic alliance with the USA. Militarily, economically and politically, bonds with America are seen by China as the most important element in international affairs for the Union collectively. Despite the many differences in policy between the USA and EU (for example, in regards to issues as different as genetically modified food, data protection, and use of the death penalty), the Chinese continue to consider that the bridge between the two continents is strong, as evidenced by defence cooperation through the North Atlantic Treaty Organisation (NATO), ambitious economic goals for a TTIP, and a shared cultural heritage that prioritises political pluralism and individual human rights.[20] This belief is manifest amongst China's political elite despite the growing warmth in relations that appears to be underway with individual EU member States.

As already mentioned in Chap. 4, China has experienced first-hand how its own expectations can be disappointed by US intervention in European decision-making affecting Chinese interests, such as the decision of the EU not to lift the arms embargo imposed after the 1989 military crackdown by Chinese troops in Beijing's Tiananmen Square. Whilst it is certainly the case that EU Member States were far from united on this issue, by early 2005 momentum appeared to be gathering behind abandoning the embargo and replacing it with a more flexible Code of Conduct for arms exports. Arguments by leading arms-exporting Member States, and in particular France, that the moment had arrived to re-evaluate the EU's relationship with China, and that lifting the embargo could be a positive indicator of seriousness in this intent, appeared to be gaining traction in many European capitals, to the consternation of the US administration. However, after the Americans expressed their grave concerns over any prospect of high technology arms sales being made available to China, citing the argument that they could one day be used to alter the balance of power in East Asia towards China's advantage in any future conflict with the USA (for example, over Taiwan), the emerging European political consensus rapidly unravelled.[21] The embargo has remained in place ever since with little prospect of any change, much to the frustration of China.

Events such as the arms embargo negotiations remain in the memory as a symbolic yet potent example of EU capitulation to US demands, seen by the Chinese as characterising the EU's failure to accord their strategic relationship with China the respect it deserves.[22]

## Challenges for the EU in Building Regional Relations Across East and South East Asia

The EU's limited role in both shaping and engaging with decision-making structures within the Asia-Pacific region is another example of how European influence is seen as being increasingly ineffectual in the face of growing Chinese economic influence, on the one hand, and a more energised security posture from the USA, on the other. The EU's institutional engagement across East and South East Asia in particular is underdeveloped.[23] It has become squeezed between the need of the region's states to accommodate China as a re-emerging power and their principal economic partner whilst negotiating a security hedging strategy with the USA as the world's leading military power.[24]

Furthermore, structural constraints exist in the design of some of these regional bodies that militate against successful engagement by the EU. In respect to ASEM, for example, the body lacks a permanent secretariat which inhibits policy coherence between meetings and, according to some commentators, has now grown into an unwieldy "talking shop" of over 50 current members.[25] Measures to upgrade inter-regional dialogue with the EU to achieve concrete outcomes in economic and investment cooperation through ASEM-sponsored agreement have failed to garner sufficient pan-Asia support.[26] The EU's engagement with the Asia-Pacific security-focused ARF and the Shangri-La Dialogue in defence policy has also been somewhat haphazard and inconsistent. In this context, the Union's approach to cooperative security does not yet appear to have gained traction with prospective East Asian partners, despite the optimism expressed by EEAS diplomats.[27]

These problems are often explained by contrasting Europe's distinctive soft-power diplomacy, that cannot effectively connect with the hard power concerns prevalent across East and South East Asia, with the military capability that only the USA can provide to underpin regional stability.[28] Whilst some scepticism persists across the region's capitals over the extent to which America's strategic rebalancing of military priorities towards Asia may merely be political rhetoric, US policy has at least been seen as reflecting greater visibility within the Administration of the importance of the American commitment to maintaining stability in the Western Pacific.[29] The challenge for the EU, by contrast, has been to promote any kind of strategy in the region, save what some have termed the realisation of "ad hoc achievements in particular policy areas."[30]

To be fair, there has been some progress in building visible cooperation. For example, one such ad hoc achievement is the EU's contribution to the design, creation, and launch of the ASEAN Economic Community (AEC) in December 2015. Creating an AEC has been a longstanding goal for ASEAN and is part of a strategy to lend greater coherence to its own policy agenda for its membership, in realms such as promoting economic development, enhanced security cooperation, and cultural convergence through the construction of a common identity.[31] The EU's technical assistance programmes offered in support of developing the AEC, together with Europe's long experience in evolving intra-regional economic integration, have been widely recognised as examples of positive engagement that build on European capabilities that are distinct from those of the USA.

This kind of inter-organisational cooperation has been characterised by European diplomats as showing how each of these two economic communities has "a common DNA."[32] There are, however, formidable challenges facing ASEAN Members in delivering on the promise of closer cooperation across a membership of such diverse economies, with intergovernmental oversight as the operational norm in keeping with ASEAN principles rather than any form of supranational control akin to the EU's approach. This makes it likely that progress towards a more meaningful cooperative model within the AEC is likely to emerge only slowly. Nevertheless, EU–ASEAN collaboration over the AEC remains at least one illustration of how a European-inspired agenda can find resonance in South East Asia when it overlaps directly with the Association's own priorities.[33]

A greater degree of strategic coherence from the EU in projecting its policy priorities in the South East Asia region may now finally be emerging in ways that can contrast with the US presence. In May 2015, the European Commission and the High Representative issued a Joint Declaration on the EU's policy initiatives with ASEAN in the fields of trade, research and innovation, transport, and sustainable development, with each broad sectoral dialogue containing specific initiatives linked to differential levels of funding and expected outcomes that presumably could be measured in future reviews. Backed by the leadership of the EEAS, this document aims to offer "a new momentum in EU–ASEAN relations."[34]

In particular, the new strategy document includes an extended section on cooperation over security issues. This could be interpreted as an attempt to counter the perception that the EU is largely an economic and trading bloc with few meaningful security interests or capabilities. It outlines a vision whereby the EU's security engagement offers ASEAN "multiple

strategic options and centrality as the big powers [read, China and the US] assert themselves more forcefully in the region."[35] It remains to be seen whether this presages a meaningful upgrading in security cooperation but it may illustrate a renewed sense of purpose within the EEAS leadership to re-engage with Asian nations more visibly in ways that matter to them.

A litmus test of the EU's credibility on both political and security related matters could be Union membership of the East Asia Summit (EAS). The Summit's wide-ranging policy remit includes security, energy policy, regional trade integration, and broader-based collaboration to achieve economic development, all of which would overlap closely with the renewed vigour that the EU's strategy document implies. Indeed, the prospect of EU membership of the EAS was made possible when ASEAN modified the Treaty of Amity and Cooperation to enable the document to be signed by organisations as well as by states, as a prelude for accession to the Summit as a full member by the EU. Officially, the EU remains wholly committed to joining the Summit but the decision is one for the ASEAN membership to confirm, some of which may be of the view that extending membership to an unconvincing security actor may not be in their interests. Furthermore, European diplomats have acknowledged that commitment on both sides will be required for the EU's accession to happen.[36]

The May 2015 Joint Declaration introduces a possible direction of travel that could lead to the EU's future accession to the EAS sooner rather than later if rhetoric is a precursor of more manifest progress. Yet, as of December 2015, Union membership of the EAS had not materialised, despite the appointment of the first EU Envoy to ASEAN.[37] Whilst this situation may well be due to divisions between ASEAN members over expanding Summit membership, past perceptions of the EU's muted support and lacklustre approach to negotiations for accession may have created the impression that the Union has largely outsourced any meaningful regional role to the USA.[38]

Overall, European responses to the changing structure of power in the Asia-Pacific region, and to China's growing significance in particular, have appeared rather haphazard. Beyond narrow and specific policy initiatives, such as technical assistance in support of the AEC, current evidence suggests that in the Asia-Pacific region, the EU has failed to construct a coherent and credible engagement agenda. Whilst part of the problem may be a mismatch between European and East Asian views on how a multilateral system should operate, which may itself originate in the EU's adherence to the principles of effective multilateralism as its own driving

force at the international level, another explanation may be that European politicians, and Union-level actors in particular, have simply had other priorities, particularly in the EU's neighbourhood. This apparent lack of cohesion and absence of strategy may be directly addressed in the EEAS 2016 Review, but it remains to be seen whether these much-heralded plans will become the basis for meaningful action.

## The US Role as Global Hegemon in EU–China Relations

Is it now time for the old certainties of EU–US attitudes towards a re-merging China to be re-evaluated? There is some preliminary evidence to suggest that the China dimension in regional and global affairs could put long-established principles of European–American mutuality under stress. A view does seem to be emerging within the policymaking elites in some EU capitals that a more measured and nuanced response to developments in the balance of power in international affairs, which takes greater account of China's position, may serve national interests more effectively in a number of foreign policy and economic areas. It has been shown in this chapter how key EU Member States have signalled that their future bilateral relations with China should no longer be seen uniquely through the prism of transatlantic relations, whether by deciding to join the Chinese-led AIIB against US advice, or by deepening economic and cultural ties with China notwithstanding growing US unease over Chinese military assertiveness.

Yet, how much of this evidence is sufficiently strong to indicate that US influence in shaping the character of European relations with China will diminish in the near term? Even when taking account of the clear potential for different policy responses across Europe to future Chinese initiatives, do these events indicate a dilution of solidarity between the US and European view of global order? The USA has been a longstanding ally of Europe in economic and security terms, with nearly all EU Member States being NATO members. The USA as a liberal democracy is also a normative partner to the EU on many points of political philosophy, whilst the two economies also share leadership of key multilateral institutions which wield substantive power in global governance, especially within those pertaining to international trade and regulations for the knowledge economy. Indeed, in the context of economic governance, and much to China's frustration, the EU has shown little willingness to relinquish its privileged status within current arrangements. Whilst the underdeveloped character of European security engagement in East Asia has inevitably led

to the Union playing a secondary role to the dominant position of the USA, facilitated by the might of its military power, there has never before been reason to doubt that the EU would support the principle of American leadership in post–Cold War international relations. Europeans have appeared largely content to operate within a US-led global order.

What does the current role of the USA imply for the future of EU relations with China at the global level? The USA is a strategic rival to China in the East Asia region and at the same time is also the world's leading economic and military power. This unique position grants America meaningful room for independent action, often in ways that are unrestrained by the very multilateral system that it helped to establish and currently leads. This introduces areas of relationship tension and prospective policy collision with China whose status as a re-emerging power reinforces a world view that sees US strategy anchored on the principle of China's containment.[39] Leading Chinese commentators have characterised US behaviour as an example of double standards enjoyed by the hegemonic state, which may help to explain China's enthusiasm for multipolarity as a global system capable of limiting hegemonic unilateralism more effectively than the current mosaic of US-led multilateral institutions.[40] The EU, however, has shown no enthusiasm for such solutions to current global problems and there appears to be no appetite amongst Europeans to follow China's strategic vision of a multipolar future.

Perhaps the strongest deduction that can currently be drawn from this medley of conflicting signals is that an absence of "grand strategy" at the EU level in respect to its relations with China is becoming a critical weakness in dealing with a fast-changing international environment that is having to come to terms with a Chinese dimension to many policy issues.[41] This is something that the leadership of the EEAS recognises as needing to be changed—a vacuum that needs to be filled.[42]

## Conclusion

The role of the USA as global hegemon continues to shape the EU–China relationship in multiple ways, not least because it illustrates how Europe continues to be influenced both bilaterally and multilaterally by the importance that it places on the transatlantic alliance, in economic, political, and cultural terms. Nevertheless, change is detectable as individual EU Member States exercise their right to negotiate a place in new institutions within an emerging global order that may no longer be the exclusive preserve of Western thinking and leadership. In particular, an erosion of

the uniformity of EU attitudes towards the transatlantic alliance appears to becoming more visible, with the propensity of Member States such as Germany and the United Kingdom to take an increasingly more nuanced view of when, and whether, traditional transatlantic ties should always trump more recent Sino-centric mercantilism. These tensions have become sharper as China's capacity to act at the global level has strengthened and its confidence in projecting its own normative principles has deepened.

These developments are in their early stages but they pose some uncomfortable questions for the EU as the century approaches its third decade. It seems clear that the EU will need to find a careful political balance in its foreign policy between reaching out to re-emerging powers such as China and, at the same time, reassuring old allies such as the USA. Constructing a coherent response to these developments will be critical in reinforcing the EU's credibility as a distinct international actor capable of exerting influence over China, across the East and South East Asia region and beyond.

There is as yet no agreed blueprint for an EU strategy on how to engage with the shifts in power dynamics that now appear to be underway, but there is at least recognition in Brussels that this vacuum should not persist. The Global Strategy Review is an important initiative in this context. However, there needs to be much more than recognition of the problem by Union officials. The design of a coherent approach to address the tensions uncovered in this analysis will require acceptance by the Member States of the need both to bridge their differences and to reinforce collective competences where necessary.

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CHAPTER 10

# Conclusion: Optimism or Pessimism about the future of EU–China Economic Relations?

This book has offered evidence to support a wide-ranging analysis of the EU–China economic relationship, based on an examination of the bilateral links between the two economies in Chaps. 4–8, as well as the approach of China and the EU to the global institutional framework and the political context within which they cooperate and compete (in Chaps. 3, 8 and 9). This concluding chapter will bring together the findings of the preceding chapters in order to assess the prospects for future EU–China economic relations.

It will first recall the main findings of the analysis in respect of the common interests, complementarities, and potential for economic synergy of China and the EU, as well as the signs of stress, strain, or deadlock in their economic relationship. A second section will then examine the main political obstacles to closer EU–China cooperation that have been identified in the analysis, on both the Chinese and EU side, to assess the relative significance of each as a potential roadblock to cooperation and its likely durability. In a third section, the main areas of EU–China economic interaction that have been discussed (international economic governance, trade, investment, research and innovation, monetary policy, and sustainability policies) will be divided into the most and least promising for the development of EU–China cooperation over the next five years.

The concluding section will underline the limited prospects for an ambitious EU–China economic partnership and emphasise the need for the EU side to define a new and perhaps more modest strategy in respect of its future economic relations with China.

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## Gaps between Potential and Performance in the EU–China Strategic Partnership

China and the EU have many common interests, the societal goals of their governments are similar in a number of respects, and they could offer complementary knowledge, skills, and resources to each other that would provide a significant contribution to the next stage of their respective economic development. But they are constrained by political differences and divisions, some of them internal to China or to the EU, that stand in the way of such cooperation.

### *Potential for Partnership*

China and the EU are oriented towards the wider world as traders and investors, but they have common interests beyond the purely material one of making a living. They have many similar characteristics. They are both large economies in transition, with rapidly ageing populations and relatively few natural resources, largely dependent on external supply of raw materials and energy, living on their wits, committed to achieving a knowledge-based society, and dealing with the social problems which that implies, supportive of publicly funded health and social security systems.

In the past 20 years, as China has become more aware of the cost to its environment and to its citizens of very rapid economic growth, the EU and China have developed broadly comparable policies to meet the economic and environmental challenges that are common to both. The preceding chapters have identified their policy focus on environmental sustainability, including alternative energy development, reduction of greenhouse gas emissions, and recycling, on the acceleration of innovation and the effective exploitation of research results, and on sustainable urbanisation. Other policy areas of mutual interest could be added: the exploration of space, the improvement of agricultural productivity, the search for cost-effective health systems. Chapters 6 and 8 have described how China and the EU have chosen to cooperate on a wide range of policies, extending well beyond the traditional focus of trade relations, where they exchange views and attempt to construct long-term cooperation. Their combined work on the development of carbon emission trading systems in China or in international negotiations for climate change reduction, for example, is a striking, even surprising example of success, in which their policy positions have occasionally seemed closer to each other than to the position of the USA.

The complementarity between European and Chinese resources and talents goes well beyond the limits of their 40-year-old trading relationship, in which each side has supplied a leading market for the other's goods and, in China's case, also made its low-cost production available to be integrated into the global supply chains of foreign companies.

A first element of complementarity is the potential common interest in developing China as a market for services as well as goods. Services have now overtaken manufacturing as the main source of employment and economic growth in the Chinese economy yet China is one of the world's lowest importers of traded services. More efficient and competitive service industries in China, including financial services, would help to generate more economic growth in China by lowering costs for other producers, as well as provide a major additional market to European suppliers.

A second complementarity is China's potential as a source of finance for economic recovery and growth in Europe. China has surplus capital to invest, whether in the form of the financing by its state-owned banks and other sectorial SOEs of energy and transport infrastructure, or of private investment by Chinese companies to supply much-needed capital for the growth of specialised European manufacturing companies. Chapters 5, 7, and 9 have identified how China has already demonstrated its readiness to support economic recovery in the EU, by inviting the EU to bring forward projects for the One Belt, One Road initiative, by supporting the Euro, and by creating a €10 billion fund for investment in the development of Central and Eastern European economies focussed on infrastructure projects. It has also offered to participate financially in the EFSI, designed to leverage private capital with public funds.

The EU, for its part, is in a position to offer a re-emerging China some of the skills that it needs, because of its longer experience of a service-driven, knowledge-based and ecologically minded economy. Chapters 4–6 and 8 have identified the potential European strengths that could make a real difference to the pace of China's development. These include experience of setting up the structures needed to generate an innovation-oriented society, with well-tried systems designed to build bridges between research and business; the banking and other financial service expertise to improve efficiency in China's financial markets; management expertise (in team-building, marketing, or quality control) that China occasionally lacks; a high standard of research output in basic or blue-sky research, where China is relatively weak; diversity in national health and social security systems; and experience in tackling the environmental problems that have now become such a high priority for China.

### *Performance of the Partnership*

The analysis of the preceding chapters has, however, also shown that the reality of the EU–China Strategic Partnership often falls short of the rhetoric of political leaders. Chapters 2, 4, and 5 have highlighted the astonishingly rapid growth of EU–China economic interdependence in the past 40 years. Trade has increased more than a 100-fold in that time; Chinese direct investment in the EU has quadrupled since 2011. Both sides have expressed a wish to participate in each other's regional funding agencies for infrastructure development. Yet alongside these positive signals, there are signs of paralysis, inertia, and sometimes mistrust in key parts of the EU–China relationship.

- Within the basic economic building bloc of the EU–China economic relationship, trade, all is not well. Overall trade growth is slowing down: the total level of exchanges has remained fairly stable in recent years as economic growth has been close to zero in Europe and has slowed down to half its level of ten years ago in China. The familiar trade problems persist (the long-standing trade imbalance, in large part resulting from China's resistance to competition from trade in services, or the EU's continuing refusal to recognise MES for China) whilst the negotiations to improve trading arrangements, such as on China's accession to the WTO GPA or rules to constrain China's export credits, are deadlocked.
- EU flows of direct investment to China are falling compared to their peak of ten years ago, as European companies complain about discriminatory treatment and uncertainties in the regulatory environment in China, and negotiations for a BIT are proceeding slowly, despite a joint EU–China commitment to make this agreement a priority.
- Joint interests in the energy efficiency or climate change field are not leading to the development of substantial joint projects between European and Chinese enterprises, despite several years of trying and the commitment of significant funding by the EU side.

EU–China interdependence may still be growing measured against some yardsticks (Chinese direct investment in Europe is increasing quickly, for example), but there has been no progress since China's accession to WTO in 2001 towards building stable and permanent arrangements that will assure a higher degree of interdependence. Negotiations or consultations about new

forms of cooperation that would involve significant concessions by either side, such as the BIT, seem to be stalled. The take-off of joint projects in the form of active participation by businesses seems to be largely one-way: Chinese companies build European motorways, railways, and power stations (even nuclear installations are not excluded in one Member State) but not vice versa. Similarly, China's participation in joint research with the EU means Chinese researchers being involved in European projects, not European researchers joining Chinese projects. Some commentators have spoken of a "trust deficit" between the EU and China because of these disappointed hopes.[1]

Today, the EU and China appear to be close to the limit of what is possible within the present cooperative framework for economic cooperation. But the fundamental changes of attitude or policy needed to produce a different framework are not in view. As the following section will recall, each side faces political difficulties in adapting its policy to new circumstances, and some of these may not be susceptible to change in the foreseeable future.

## Relative Importance and Durability of Political Obstacles to Closer EU–China Economic Cooperation

The analysis of the previous chapters has shown how politics can get in the way of what would otherwise appear to be a profitable and positive matching of interests between China and the EU. Fundamentally, different views about the relations between the state and society, or the state and its international environment, exist not just between China and the European Union but also between the Member States of the European Union. In relation to the direction and pace of economic reform in China, different views are also found amongst the leadership of the CCP.[2] They considerably reduce, if not entirely remove in some cases, the possibility of a more open and productive economic relationship between China and the EU.

In this section, the main political obstacles to closer economic cooperation between the EU and China identified in earlier chapters will be reviewed to assess their importance and durability. The importance of an obstacle is measured in terms of the range of policy areas or activities it affects (some will affect all areas, others may be relevant in only a few). Durability is assessed in terms of the likelihood of a change of policy in the medium term (i.e., within the next five years).

### *Political Obstacles in China*

Four political obstacles to EU–China economic cooperation stand out as deserving consideration:

- Absence of the rule of law
- A nationalistic view of economic management
- Political control of key sectors of the Chinese economy
- Uncertainty of economic reform.

(a) *Absence of the rule of law*

The underlying problem here is that the Party-State as constructed in China is not subject to the normal constraints of the domestic legal system that might be expected under conventional principles. Rather, the Party uses the law for instrumentalist political purposes in many instances, exhibiting what might be termed a preference for rule by law rather than rule of law. It can interpret law at will and provide political steer to the decisions of courts, showing that the Party effectively stands above the law in China today. Earlier chapters have shown how absence of the rule of law in China can affect economic activity in a variety of ways: by introducing uncertainty into the acquisition of business premises, through poor enforcement of protection of intellectual property, through arbitrary or unpredictable regulatory change in relation to direct investment, or through interference in the running of financial institutions, such as stock markets. Absence of the rule of law also affects the rights of workers, consumers, or environmental activists within the economy.

According to the European businesses established there, absence of the rule of law ranks as the number one problem in dealing with China. It allows the administrative authorities to act as they see fit and to reach occasionally arbitrary conclusions that are difficult to challenge. Even if the present Chinese government does not choose to exercise this extraordinary power often, it has the possibility of doing so anywhere and at any time. In terms of durability of this obstacle, the CCP shows no sign of changing its approach to this issue. The Third Plenum in 2013 announced changes (such as fairer operation of the courts and the suppression of corruption) and the Fourth Plenum, dedicated to the subject of rule of law in 2014, took some first steps to ensure more

harmonised application of rules for the operation of courts, but the independence of the CCP from the reach of the law has not been put in question. The rigorous suppression of those in China who advocate constitutionalism as an answer to improvement of the rule of law suggests that the Party will not tolerate any public debate about removing its most fundamental power.

(b) *A nationalistic view of economic management*

Earlier chapters have indicated how China seeks to be autonomous (through indigenous innovation, Chap. 6) or the first and the best (through promotion of patenting, Chap. 6), and how this induces a reluctance to develop two-way partnerships or to admit external dependence (sustainable economic development, Chap. 8). China has recently taken the initiative to create new international funding institutions, such as the New Development Bank and the AIIB, and to launch continental-scale economic projects such as the One Belt, One Road initiative (Chaps. 3 and 5). The "Chinese Dream," first publicly enunciated by President Xi Jinping in November 2012, aims at the rejuvenation of the Chinese people, both domestically and on the world stage, based on a Chinese spirit.[3] National pride that is an understandable part of this vision may also be used as an ideological underpinning for unfair treatment of foreign enterprises (Chap. 5). This may, in turn, create attitudes that are unhelpful in building the international cooperation and intercommunication that is essential for developing economies to reach the next stage of their economic development, the knowledge-based economy (Chaps. 2 and 6).

A sense of pride in China's recent achievements ranks high in terms of shaping attitudes to international relations in China, although it is difficult to assess its practical importance. Nationalism in China is reinforced by government control over the media and the emphasis given by the government to territorial disputes with China's neighbours in the maritime regions off the country's Eastern seaboard. China's economic relations with Japan, for example, have been severely affected by such issues.[4] The public prominence given to President Xi's Chinese Dream reinforces the impression that nationalism has replaced Marxism as the ideological basis for CCP authority in China. Its durability seems certain to exceed the next five years.

(c) *Political control of key sectors of the economy*

The larger part of China's output is still in the hands of the state. As the Third Plenum reform decisions made clear, the state-owned sector is still seen as essential to China's economic future, and privately owned business as ancillary to it. Earlier chapters have explained the extent to which SOEs, under the direct control of the CCP, dominate the Chinese economy at every level. Energy, telecommunications, transport, and banking are some of the main economic sectors concerned and, as Chap. 5 indicated, these are the ones where EU firms consider themselves competitive and are looking for market opening.

Whilst perhaps not as durable as the two political obstacles mentioned above, any change in state control of the economy is likely to be slow. The slow reaction of the authorities to chronic overcapacity in the state-owned steel sector is an indicator of that. The Third Plenum decisions emphasised the leading role of SOE actors throughout. For reasons of efficiency, the Chinese government may wish over time to reduce the number of failing SOEs, but there has been no suggestion of reducing the dominant role of the public sector as a whole. The closure of China's government procurement market to foreign competition for 15 years after China's WTO accession is another sign of Chinese reluctance to give ground on this issue.

(d) *Uncertainty of economic reform*

Earlier chapters have illustrated how China will find it difficult to move forward quickly with economic reform, even if substantial parts of the Chinese elite are convinced about the need for it and its potential benefits in terms of greater efficiency and international competitiveness. The tentative and ambivalent language of the Third Plenum decisions regarding issues such as opening up of the Chinese market to international competition (Chap. 4) or financial and monetary reform (Chap. 7) show how critical aspects of reform for the EU–China economic relationship are subject to uncertainty, not only with respect to timing but also on the principle of reform. The leadership has been firm about its intentions and some aspects of economic reform, such as the anti-corruption campaign, have been pursued vigorously, but there is deep uncertainty about the leadership's ability to deliver radical change within a timescale that is relevant for China's international partners, which are actively pursuing alternative bilateral or multilateral arrangements for deepening economic cooperation that do not include China.

China's economic partners recognise that the speed of reform remains a matter of careful judgement for the Chinese government but the lack of pace so far in critical areas for European interests (such as market opening and liberalisation of inward direct investment) has been a disappointment for the EU. Whilst the position of the Chinese government could become clearer within the next five years, that is not a certainty.

### *Political Obstacles in the EU*

Turning to the political obstacles on the EU side to closer EU–China cooperation, there may be fewer of them, but their importance and potential durability match those on the Chinese side. Two in particular deserve attention:

- The absence of a clear EU strategy towards China
- Priorities other than China

#### (a) *Absence of a clear EU strategy towards China*

The lack of an EU strategy towards China since the economic crisis is surprising, given the transformation of the global economy by China's accelerating re-emergence in the course of this century. The last EU political strategy statement on China dates from 2006. Since then, negotiations for an EU–China Partnership and Cooperation Agreement (PCA), begun in 2007, have run aground and yet nothing appears so far to have taken its place. The EU–China 2020 Strategic Agenda for Cooperation, agreed with China in 2013, is an extensive task list without the political and legal framework necessary for achieving it. Whilst the EU does not have a formal framework for its economic relations with other important economic partners, such as the USA, the shared values between the transatlantic partners have led them to commit to negotiate an ambitious trade and investment partnership that will in time set a comprehensive framework for their economic relations.

As the preceding chapters have shown, the EU has been unable to agree a similar common stance towards China, and the EEAS Communication on the EU external relations strategy promised for 2016 may not propose a specific China-oriented policy. There appear to be two distinct reasons for this.

The first is the existence of serious policy differences between the Member States on how to deal with an economy like China's. Chapter 4

indicated differences in relation to trade defence measures, Chap. 5 in relation to inward investment from China. These disagreements stem from different attitudes to competition and the benefits of structural change in economies. Whilst these policy positions may evolve over time, short-term change is unlikely.

The second reason is reluctance, especially on the part of the bigger Member States, to allow Treaty obligations to develop a common external economic policy to be implemented in practice. This is more than formalistic hostility towards a reallocation of competences. It is grounded on the sometimes intense competition between Member States in their external trade and investment policies, and the fear that the negotiation of a common EU approach towards an economy as big as China's could involve concessions on details that might reduce the room available to a Member State to defend its interests effectively. Frequent high-level political missions from the EU Member States to China reflect the potential value of bilateral relations with that country in the eyes of national ministers. There is no indication that the pressure to agree a common line towards China will become greater than the pressure to remain free of EU-level discipline anytime soon.

(b) *Priorities other than China*

The past decade may have been the fastest period of development of EU–China economic relations, but it has also been the most testing period for the EU in terms of its domestic economic policy and its foreign policy. The post-2008 financial and economic crisis and the instability of the neighbourhood region to the EU's East and South, with war practically at the EU's borders in Syria and the Ukraine and extensive migration into the EU from North Africa and the Middle East, have meant that the EU has had to concentrate on other more pressing matters than its relations with China. In the field of external economic relations, the EU has devoted its negotiating energies to developing relations with like-minded developed economies, such as the USA, South Korea, Singapore, and Japan, rather than spend time trying to convince China to move forward from an entrenched position. These other priorities will remain for some time to come, and the new impetus given to the WTO by the final abandonment of the stalled Doha Round negotiations in December 2015 may reawaken interest in multilateralism.

Many, if not all, of the political obstacles to closer EU–China economic cooperation appear, therefore, to have staying power. The only obstacle that may become less severe in the next five years is uncertainty about the Chinese government's commitment to economic reform, but even that will continue to be constrained by the positions of principle of the CCP on the rule of law, state control of the economy, and a nationalist vision of economic development.

## Most Promising and Least Promising Areas for Cooperation

Having assessed the relative weight of the major political challenges in both China and the EU, this section considers which of the policy areas discussed in the preceding chapters are the most or least promising for improvement of EU–China economic cooperation.

### ***Promising Areas***

(a) *Governance of global economic institutions*

The recent agreements to increase China's degree of influence within the IMF, in respect of its voting power and the inclusion of the RMB in the SDR basket from 2016, serve to indicate to China that international economic institutions can, after all, accommodate its interests—although they may also be seen as the result of China's firm position on the injustice of its previous treatment. The stance of the EU Member States, previously assumed to be defensive of the *status quo* and their position in it, is moving in the direction of accommodation of China. The IMF SDR decision is one pointer; participation of EU Member States in the AIIB is another. This does not, therefore, seem to be an area characterised by conflicting positions that are unlikely to change in the medium term. China is a part-revisionist, part-conformist power, and is therefore likely to be cooperative in some areas of global governance and obstructive in others. In conclusion, this may be one of the more promising areas for future EU–China cooperation.

(b) *Sustainability cooperation*

Energy, environmental, and climate change policies are issues where China and the EU have powerful motives to move in the same direction. In most of these areas, the EU has been a pathfinder in developing sustainable economic policies and technologies. China has recognised that it has a severe problem in all of these areas, is adopting a broadly similar set of policies to the EU, and has proved that it has the capacity to implement policy change quickly (by investment in alternative energy supply, for example). China recognises European technical and regulatory achievements in these areas and has been interested in cooperation with the EU to learn more. From the EU side, there is a double interest: first, in helping China achieve its own objectives whilst reducing the overall pressure on global resources and, second, in creating opportunities for EU businesses to market specialised goods, services, and expertise in these areas in China. Hence the willingness of the EU to expand the range of EU–China policy dialogues in this area over the past ten years, accompanied by considerable budgetary support.

However, evidence of concrete achievements through cooperation is slight. EU–China contacts take the form of exchange of ideas in seminars and workshops, not of joint business ventures and more open markets. There is very little practical cooperation between EU and Chinese companies. China's need to create new jobs for its population in emerging technologies, and its traditional development model of encouraging the growth of national champions through market protection and subsidies, make it unlikely that significant market opportunities will be offered to non-Chinese competitors. In addition, China's policies relating to ownership of ideas and protection of intellectual property do not provide the assurance that European investors need before they can become more heavily involved in cooperation.

This area of cooperation remains promising in terms of the likelihood of continuing transfer of knowledge to China (and therefore improved effectiveness of China's policies). It will be less promising as a source of opportunities for European companies in China in the absence of a regulatory framework in China that encourages international economic cooperation.

(c) *Monetary cooperation*

Chapter 7 described how both the RMB and the euro are currencies that suffer from policy weaknesses that affect their international use and status, although the euro as a fully convertible currency already has international standing that the RMB will not achieve without more substantial financial market reform in China, despite the November 2015 decision of the IMF to include the RMB in the SDR basket. Such reform will, however, tend to undermine state control of financial markets and, to some extent, China's industrial policy, and is likely to prove particularly challenging. This will mean that the benefits of reform, both for the Chinese economy and for EU financial service suppliers, will be delayed. This being said, China and the EU have strategic common interests in a stable monetary system, and the attitude of the EU and its Member States towards a larger role for China in the IMF has so far been relatively accommodating. Greater investment cooperation between the EU and China may contribute to a more positive climate.

The EU and its Member States have shown a positive openness to internationalisation of the RMB, but achieving that goal, and the greater balance in the international monetary system that would result, will ultimately depend on decisions taken in China about its domestic economic management.

### *Less Promising Areas*

(a) *Trade*

Chapter 4 concluded that the there was little room for either side to change its position regarding the many points of tension. China, for example, is unwilling to offer market opening to the EU on services or government procurement, the priority areas for the EU, because that would undermine the position of its state-owned companies. Marginal improvements in access may occur in relation to TBTs or IPR protection, but these are not game-changers for the EU. The consequence of this policy impasse will be continuing imbalance in EU–China trade, with the EU holding the view that its export potential to China is most constrained where it is most competitive, and particularly for services.

EU concerns about the possible impact on European businesses of China's system of subsidies to designated strategic industries will also remain a problem. Although a major political clash with China over this issue was avoided in 2014, another such confrontation could occur in future. Policy differences within the EU in relation to trade defence, however, could make a decision to adopt EU-wide anti-subsidy measures against China more difficult. The Member States that have been most assiduous in cultivating their bilateral economic relations with China, such as Germany and the UK, are traditionally cautious in respect of having recourse to EU trade defence measures.

The issue of Market Economy Status, although a technical one that has only a limited effect on EU–China trade, remains a question of major political importance for China. If the EU at the end of 2016 were to maintain its current position that China is not yet a market economy (and there has been strong internal and external pressure on the EU not to change its position), this would be seen as an unfriendly act by China and would reinforce Chinese reluctance to make trade concessions to the EU. As one Chinese interviewee put it, withholding MES for China "is like slapping your face and then saying let's be partners."[5]

Trade policy will, therefore, remain a fraught and unpromising area, which could possibly deteriorate further over the medium term.

(b) *Investment*

Growing EU–China investment links since the year 2000, and the current approximate balance in FDI flows between the two sides, might suggest that this is a promising area for cooperation. That, however, would be to ignore the imbalance of opportunity to invest between Chinese companies in the EU, which are generally, if not always, welcome, versus EU companies in China, which are either excluded or restricted in many sectors.

The slow pace of negotiation since 2013 of an EU–China BIT, which would establish more symmetrical reciprocity, confirms that this is a policy area that is politically sensitive for both sides. For China, above all, opening up to inward FDI in the excluded sectors would be a frontal attack on state-owned monopolies whose position has been defended in China's economic reform strategy. In spite of announcements made by the Chinese authorities in early 2015 about a possible new framework for inward FDI rules, there is no concrete evidence to suggest that China is ready to open its market to the EU to anything like the same extent as the EU already has to China. For the EU, too, concluding a BIT with China will require EU Member States

to define a common position on detailed questions relating to inward FDI that hitherto have been decided at national level.

Despite being the top economic priority for the EU–China 2020 Strategic Agenda for Cooperation agreed in 2014, investment policy is an unpromising area of cooperation that is unlikely to make early progress.

(c) *Research and innovation*

Chapter 6 has shown that China is growing as a potential competitor in research capability, but it is still behind the curve compared with EU leadership in key high technology areas and in disruptive innovation. EU capabilities provide an opportunity for collaboration, as China needs European technology and know-how. However, uncertainty about the reliability of the regulatory and behavioural environment in China for research and innovation cooperation, particularly regarding enforcement of IPR, could continue to discourage European involvement.

The overall assessment is, therefore, that this is an unpromising area of cooperation, as the necessary changes in the Chinese environment are likely to take some time.

## Conclusions

From this assessment, one may conclude that the overall prospects for EU–China economic cooperation are encouraging in a few areas but rather less encouraging in those that are at the core of the EU–China economic relationship. Cooperation in areas that will certainly be of importance in the long term, such as the promotion of economic sustainability and international institution building, where there may be fewer hostile vested interests than elsewhere, could grow. Areas such as research and innovation and monetary cooperation could also evolve positively if not dramatically. However, the areas of greatest immediate importance—trade and investment—are likely to reflect a fundamental asymmetry of economic opportunity between the EU and China for some time to come. The key to overcoming these problems is economic reform in China but, as this analysis has shown, economic reform brings with it major political risks that the CCP is reluctant to take.

The analysis has also pointed out weakness and indecision on the EU side: the lack of EU strategic thinking about China, the absence of a plan, and even the unwillingness of some Member States to contemplate one. The disorder in European thinking about economic interaction with China,

which will become the world's biggest economy in absolute terms within a generation, and the reluctance to devise a common approach to the many challenges it poses, could have wider political implications for Europe in the longer term. The tension between the short-term interests of individual EU Member States in cooperating with China and the formulation of a coherent European strategy to accommodate a re-emerging global power has been highlighted at several points in this analysis. Reaching decisions on these issues within the European Union will be difficult, but the problem needs to be addressed.

## Notes

1. EU–China Observer, 'EU–China Relations in a Globalised World', Issue 5 (Bruges: College of Europe, 2012), p. 13.
2. Despite some genuine progress in the reform agenda, within the elite, there do appear to be continuing differences of opinion on the pace and emphasis of reform outcomes. For an interesting discussion of these complexities, including elite disagreements over land reform, the opacity of detail concerning SOE reform, and the potential for persistence of a "protectionist impulse" in China, see Barry Naughton, 'Is There a "Xi Model" of Economic Reform? Acceleration of Economic Reform since Fall 2014', *China Leadership Monitor*, no. 46, p. 9.
3. See Zheng Wang, 'Not Rising, But Rejuvenating: The "Chinese Dream"', *The Diplomat*, 5 February 2013 <http://thediplomat.com/2013/02/chinese-dream-draft>, accessed 30 November 2015 and The Economist, 'Xi Jinping and the Chinese Dream', *The Economist Leaders: China's Future*, 4 May 2013 <http://www.economist.com/news/leaders/21577070-vision-chinas-new-president-should-serve-his-people-not-nationalist-state-xi-jinping>, accessed 30 November 2015.
4. See a discussion by Gordon Chang about how bilateral trade volumes dropped by over 5 % in 2013, in no small part linked to maritime disputes, 'The Chinese and Japanese Economies are Delinking: Prelude to Conflict?', *Forbes*, 16 February 2014 <http://www.forbes.com/sites/gordonchang/2014/02/16/the-chinese-and-japanese-economies-are-delinking-prelude-to-conflict>, accessed 30 November 2015.
5. Interview with a Chinese official, Brussels, January 2015.

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