

# THE STATE OF CHINA- EUROPEAN UNION ECONOMIC RELATIONS

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China and the European Union have an extensive and growing economic relationship. The relationship is problematic because of the distortions caused by China's state capitalist system and the diversity of interests within the EU's incomplete federation. More can be done to capture the untapped trade and investment opportunities that exist between the parties. China's size and dynamism, and its recent shift from an export-led to a domestic-demand-led growth model, mean that these opportunities are likely to grow with time. As the Chinese economy matures, provided appropriate policy steps are taken, it is likely to become a less disruptive force in world markets than during its extraordinary breakout period.



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## 1 Vital statistics

The economic relationship between China and the European Union is already extensive. While the EU is China's largest trading partner, China is the EU's second largest after the United States, and is catching up rapidly. The sustained growth of the Chinese economy and its integration into global supply chains have put China on a path to be the world's largest trader and its largest economy measured at market exchange rates – as it already is on purchasing power parity measures. China's size and the rapidity of its rise have been the cause of much disruption, but have also led to the opening up of many opportunities. Though China's growth may well continue to outpace the world average by a wide margin in the foreseeable future, there is evidence that the most disruptive phase of China's entry into world markets is behind us. Table 1 provides a summary of the Chinese, EU and US economies.

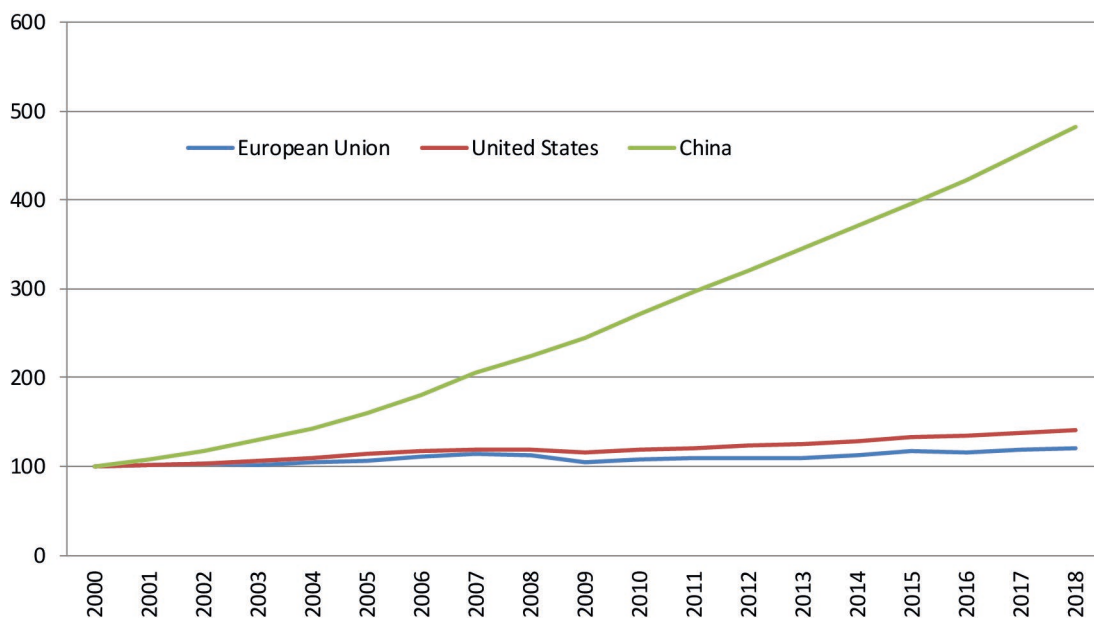
**Table 1: Overall economic picture**

Variable	China	European Union	United States
GDP (billions US\$)	13,608	18,749	20,494
GDP (PPP, billions \$)	25,363	22,732	20,494
GDP, per capita (US\$)	9,771	36,532	62,641
GDP, per capita (PPP US\$)	18,210	43,715	62,641
Population (millions)	1,393	513	327
10y GDP growth rate (%)	7.95	1.00	1.76
Current account (% of GDP)	0.36	1.44*	-2.38

Source: World Development Indicators & World Economic Outlook, April 2019 (for EU current account).

Since 2000, China's real GDP has increased almost fivefold while the EU's grew by 20 percent and the United States' by 41 percent (Figure 1). Over this period, Chinese growth averaged 9 percent and consistently remained above 6 percent. China's rapid growth rate must be seen in the context of a low initial level of development. *Per-capita* income in China is still only about one quarter that of the EU at market exchange rates, and about four tenths adjusting for purchasing power. While China has made extraordinary progress in rooting out absolute poverty (less than about \$2 a day PPP adjusted), 27 percent of its population live on \$5.50 or less a day PPP adjusted, which is the World Bank's definition of moderate poverty and high vulnerability to economic shocks. That share compares with 6.4 percent in Chile, and 1.9 percent in Lebanon, countries presently blighted by violent protests against poverty and inequality. Although there is a pervasive concern about China's competitive potential, the fact is that even in manufacturing – which accounts for the bulk of world trade – China's productivity lags far behind. In 2017, output per worker in Chinese manufacturing was \$24,470, only a seventh of the \$180,270 level of output per worker in US manufacturing (Lawrence, 2019).

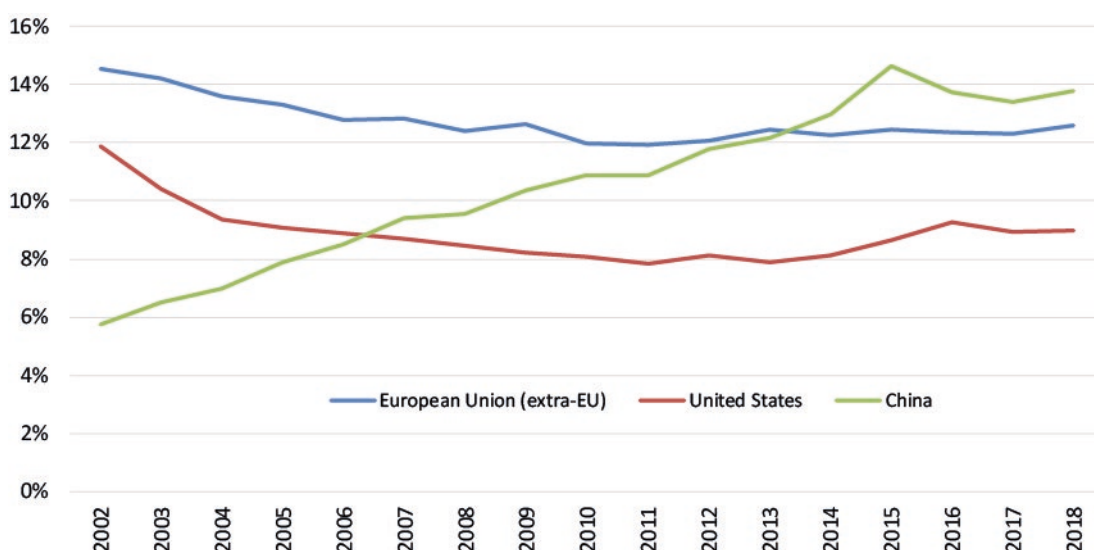
**Figure 1: GDP, constant prices (2000 = 100)**



Source: World Economic Outlook (WEO), April 2019 [gross domestic product, current prices in US dollars].

China’s exports have grown even faster than the rest of the economy, especially before the global financial crisis, but have slowed in recent years. As Figure 2 shows, China’s share of world export markets surged from 3 percent in 2000 to about 11 percent in 2015, and has since stabilised. However, China’s rapid advance is from a position of low initial integration in world markets. Even today, China’s exports *per capita* remain at about one quarter of those of the United States and one-twelfth of those of Germany.

**Figure 2: Export of goods, market shares, % of world exports**



Source: World Bank WITS (<https://wits.worldbank.org/>).

In recent years, the Chinese growth model has shifted towards one driven by domestic consumption, with the service sector rapidly gaining ground relative to manufacturing. The share of consumption in GDP has risen sharply over a short time span, from 35 percent to almost 40 percent between 2012 and

2017 (IMF, 2019), while the share of services in GDP increased even more markedly from 44 percent to over 52 percent (World Bank World Development Indicators). The surge in consumption has been facilitated by a large credit expansion and reflects the tens of millions of Chinese citizens entering the middle classes (Kharas, 2010).

Nevertheless, Chinese consumer markets remain vastly underdeveloped compared to Europe. There are about 110 cars per 1000 people in China, four times as many as in 2000, but still just one quarter the number in the EU<sup>1</sup>. Even at this early stage of its development, China's car market and production are already the world's largest by a wide margin. International travel, another indication of affluence, is booming in China: last year Chinese citizens went on more than 150 million overseas trips, compared to 30 million per annum on average during the first decade of the millennium<sup>2</sup>. According to recent projections (Kharas, 2017), China's middle class will number 1.2 billion in 2030 and, although the average person in China's middle class will be less affluent than their counterpart in the EU, the aggregate purchasing power of the Chinese middle class will substantially outstrip that of the EU.

The Chinese economy is becoming more 'normal' in some ways. Not only is it driven increasingly by domestic consumption, but in line with its Asian miracle predecessors, it appears to be on a sharply slowing trend after a period of extraordinary growth. In addition, the global deceleration that followed the great financial crisis hurt China like it did countries across the world. But the Chinese economy remains profoundly different in other ways because of the role of the state, its one-party system and the party's influence over economic decisions. In recent years, Chinese growth appears to have suffered primarily from domestic impediments – most notably slowing reforms in its state-owned sectors, the high and rising indebtedness of its non-financial corporate sector, and the regulatory response to the expansion of its shadow-banking sector. Trade tensions have also played a role since 2016.

Chinese growth slowed from 6.8 percent annualised in the first half of 2018, to 6 percent annualised in the second half. Growth is projected at 6.2 percent in 2019, according to the International Monetary Fund World Economic Outlook for July 2019. Fiscal stimulus and the People's Bank of China's (PBOC) liquidity provision and reduction of reserve requirement ratios (RRR) are helping mitigate the slowdown. The IMF's *World Economic Outlook* predicts continued deceleration of Chinese growth to 5.5 percent by 2024 (IMF, 2019). Still, trend growth in China is estimated to be about three times higher than that of the United States and four times higher than that of the European Union.

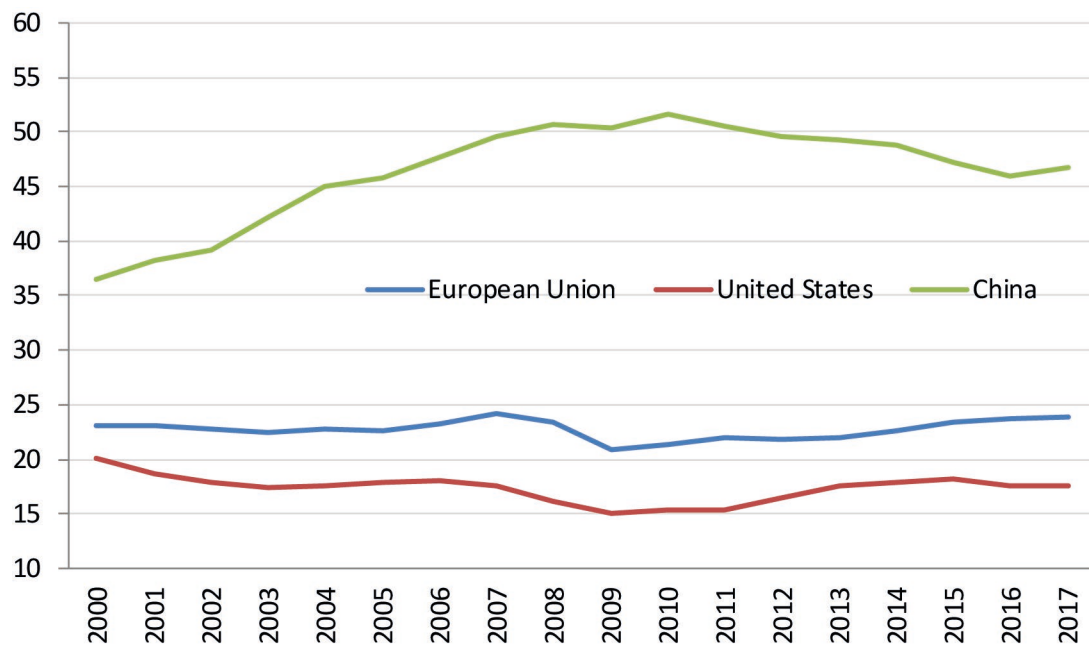
China ran a large structural current account surplus for many years. In 2007, just before the global financial crisis, it reached a peak of 10 percent of GDP. In the wake of the crisis, a combination of fiscal and monetary stimulus and increased wages that stimulated private consumption led the Chinese savings rate to plummet from high levels, from 52 percent to 45 percent of GDP. However, Chinese domestic investment rates have remained high and by 2018, the current account surplus had declined essentially to zero. China is projected by the IMF to run a small current account surplus of around 0.5 percent of GDP over 2019-2024. Some forecasters expect a deeper deficit to develop over time<sup>3</sup>. Others expect the surplus to rise again as China liberalises its capital account and experiences increased capital outflows while allowing the exchange rate to depreciate (Setser, 2019), or as the reduction in savings rates holds, but the recent surge in public investment abates (Garcia Herrero, 2019a).

<sup>1</sup> Sources: wdi.worldbank.org, Eurostat and National Bureau of Statistics of China.

<sup>2</sup> *The Economist* (2019) 'China's high-spending tourists bring political clout', 23 February, available at <https://www.economist.com/china/2019/02/23/chinas-high-spending-tourists-bring-political-clout>.

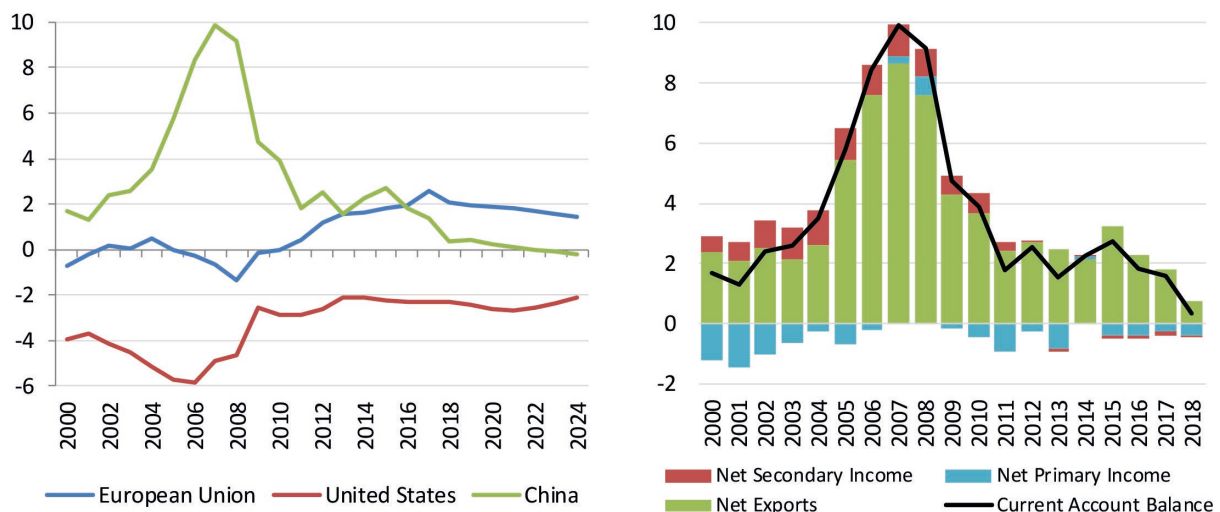
<sup>3</sup> For example, Morgan Stanley expects it to turn negative in 2019 and reach a deficit of -1.6 percent in 2030. See <https://www.morganstanley.com/ideas/china-foreign-capital>.

**Figure 3: Gross domestic savings, % of GDP**



Source: World Bank.

**Figure 4: Current account balance, % of GDP (breakdown for China)**



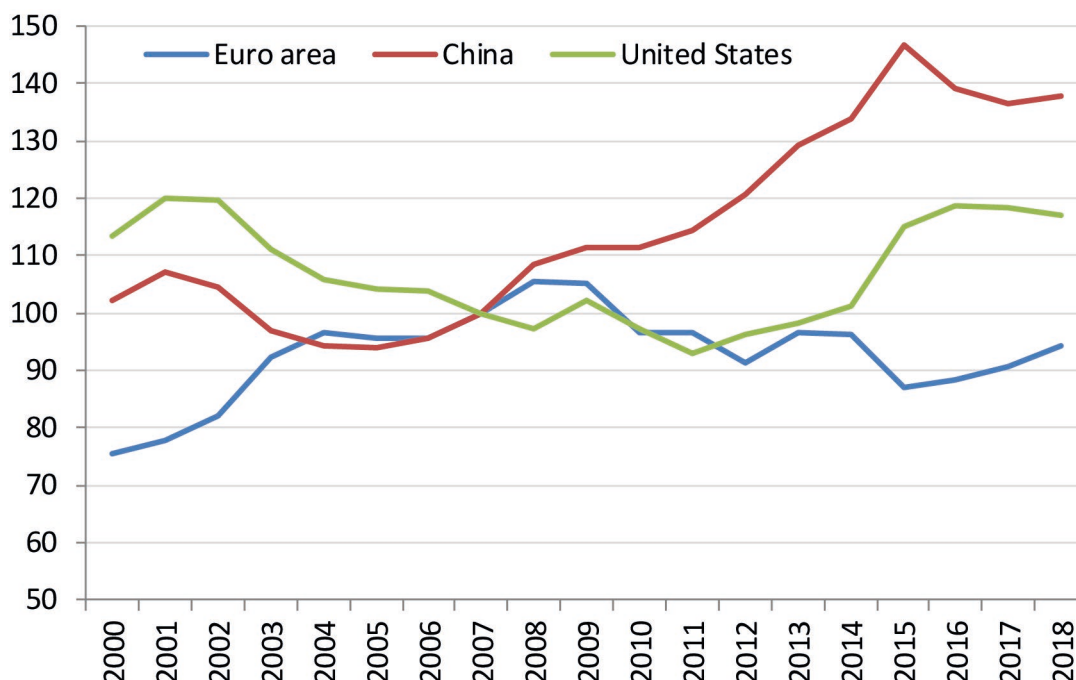
Source: World Economic Outlook (WEO), April 2019 (left panel) and World Bank (right panel).

Opinions vary, but, as the Chinese consume more of their tradable goods and services instead of exporting them, the era of massive and rapid penetration of world markets appears to us to be over. China's exports as a share of GDP are now 19.5 percent, a very high level for an economy of its size (the relative share is 12.1 percent for the US economy respectively)<sup>4</sup> and, as mentioned, have been growing less rapidly than China's GDP in recent years. Even were China's exports to maintain their share of GDP in the future, which is unlikely (one would expect that share to decline and resemble more those of the EU and the US), and were China to maintain its GDP growth premium over the world average (about 2 percent), China's export share would increase at 0.2 percent a year, far less rapidly than in the past. In

<sup>4</sup> Authors' calculation based on Eurostat Comext data.

the very long run, China's exports *per capita* will likely increase roughly in line with its GDP *per capita*, but may never come to match those of countries, such as Germany and the United States, whose populations and domestic market potential are far smaller. The implication is that, as it matures, China is likely to be a less-disruptive force on world markets than during its extraordinary breakout period.

**Figure 5: Real effective exchange rate**



Source: Bruegel based on Darvas (2012) and the Bank of International Settlements Effective exchange rate indices.

An important contributor to China's external rebalancing is the appreciation of the renminbi. China's real effective exchange rate (REER) has appreciated 40 percent since 2000, while those of the US and the EU have fluctuated without a pronounced trend (Figure 5). China's REER appreciation has contributed to reducing the current account surplus by contributing to higher real income and consumption and by reorienting the economy towards non-traded or less-traded sectors, such as services and construction, while slowing the growth of manufacturing. China abandoned a strictly pegged exchange rate in 2005 in favour of fluctuations around a managed trend, designed to gradually appreciate against the dollar. The decline of the REER between 2015 and 2017 can be explained by capital flight that followed PBOC signals in favour of further flexibility (Das, 2019). Dollar strength in recent years has complicated the PBOC's efforts to keep the renminbi to below seven to the dollar (a boundary that has recently been broken). Longer-term currency flexibility seems inevitable as the Chinese economy matures and the capital account becomes liberalised. That said, recent years have seen a tightening of capital controls, especially following the 2015 episode of renminbi depreciation. However, these were primarily put in place as a temporary protection for the weak Chinese financial system, to mitigate the large capital outflows that were taking place at the time.

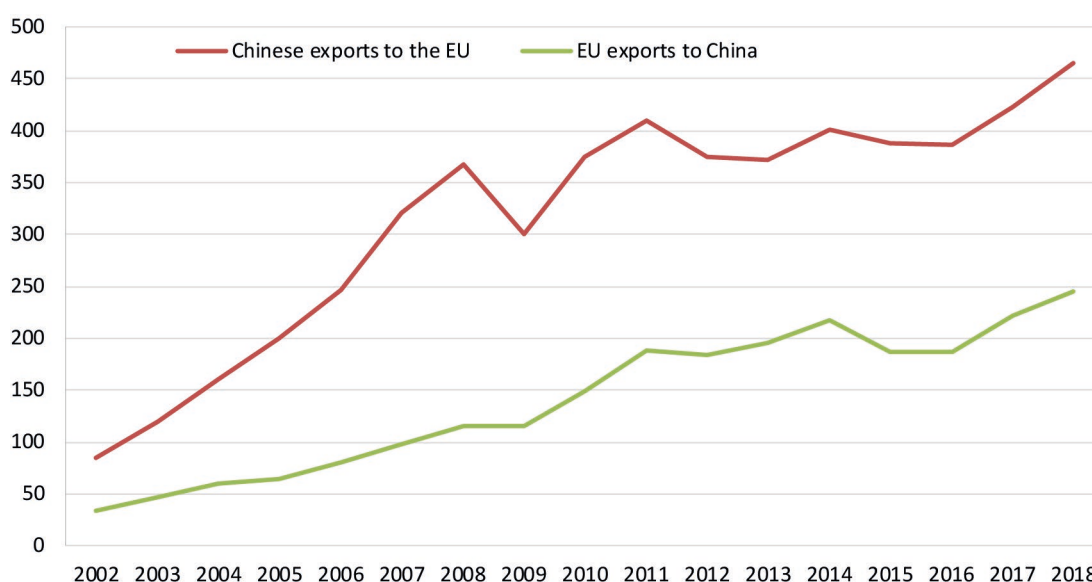
Economic theory and extensive empirical evidence has established that increased integration of markets – those for goods, services, capital, people and technology/knowledge/data – can in the right circumstances generate very large improvements in welfare. Indeed that is the premise that underpins the EU's single market, and the EU's continuous efforts to broaden and deepen its economic ties with the rest of the world. In this section, we examine the main economic channels through which China and the EU interact, beginning with trade.

## 2 Bilateral trade flows

Since China joined the World Trade Organisation in December 2001, the EU's goods exports to China have grown on average more than 10 percent a year and service exports by over 15 percent a year. This has resulted in ample benefits for EU producers and consumers but, as imports from China have also grown rapidly, it has also caused some degree of disruption in EU labour and product markets.

Currently, China is the EU's second largest export market behind the US. China's exports to the EU have grown even more rapidly and the EU is now China's largest trading partner and the second largest export market for Chinese goods<sup>5</sup>. Since 2002, the EU's trade deficit with China has grown to \$220 billion (Figure 6), equivalent to about 1 percent of the EU's GDP<sup>6</sup>. The widening of the bilateral trade deficit reflects a base effect: it has happened despite the EU's exports to China growing more rapidly than China's exports to the EU. Meanwhile, the EU's overall trade balance with the world has moved well into positive territory, while China's has moved from overall surplus to balance.

**Figure 6: EU-China trade volume (\$ billions)**



Source: World Bank WITS (<https://wits.worldbank.org/>).

As for any pair of trading partners, the trade relationship between China and the EU is best understood in a general equilibrium context, rather than from a narrow bilateral perspective. The essential point is that even if China does not buy as much from the EU as it sells to the EU, the EU runs an overall trade surplus, and this is made possible to some extent by the EU's exports to third parties which have, in turn, seen their exports to China surge. In fact, China is now the largest export destination for 33 countries out of 186 for which data is available (McKinsey, 2019). Thus, from 2002 to 2017, the EU's trade deficit with China grew on average by about 9 percent annually, but the EU's trade balance with all countries excluding China grew on average by about 23 percent annually.

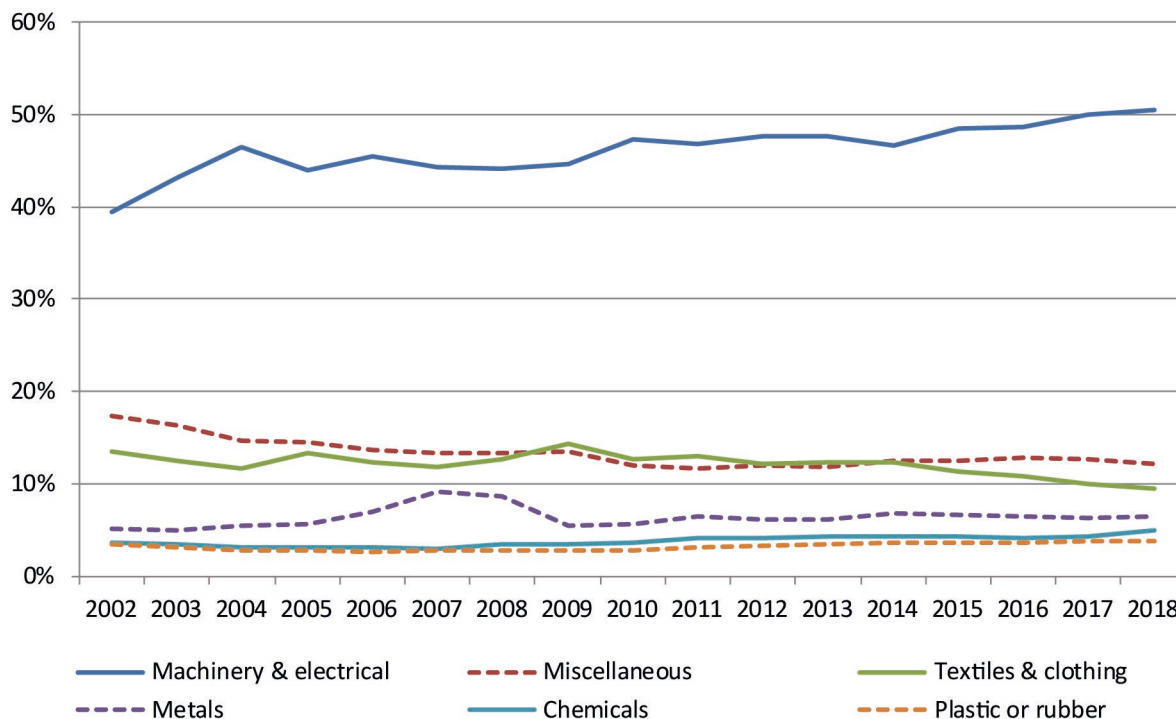
The changing composition of trade between China and the EU reflects the economic transformation China has undergone since the beginning of the millennium. As China has moved up the value chain, the share of machinery and electrical equipment imported by the EU that comes from China has grown:

<sup>5</sup> See <https://ec.europa.eu/trade/policy/countries-and-regions/countries/china/>.

<sup>6</sup> Expressing trade as a share of GDP in value added instead of grows terms would be a more appropriate measure of the bilateral trade balance, and almost certainly a smaller one.

from below 40 percent to over 50 percent between 2002 and 2018 (Figure 7). More broadly, capital goods have overtaken consumer products as the main category that the EU imports from China, accounting for half of total EU imports from China in 2018.

**Figure 7: Share of EU imports from China by product category**



Source: World Bank WITS (<https://wits.worldbank.org/>).

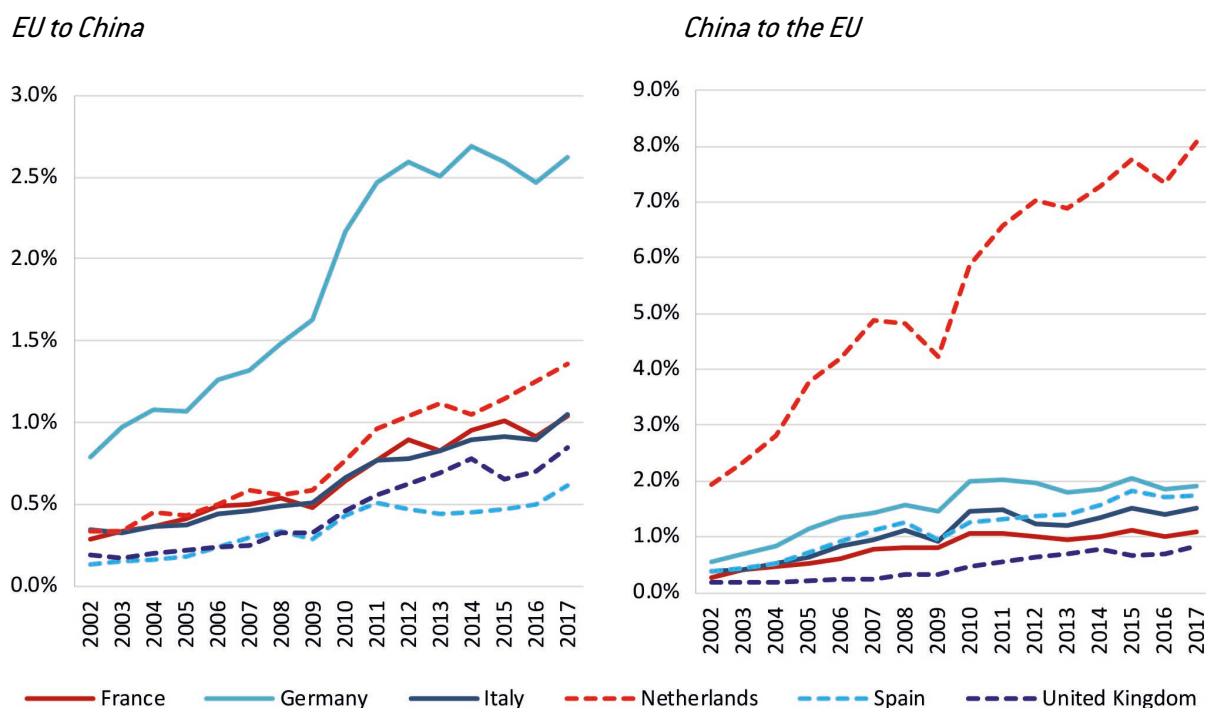
Meanwhile, the share of the EU's exports to China that consists of machinery and electronic equipment declined significantly, from above 50 percent in 2002 to 30 percent in 2018, while China's imports of EU transport equipment, including vehicles and aeroplanes, and of chemical products, gained ground steadily. In terms of broad categories, the share of capital goods in the EU's exports to China declined by around 15 percent, whereas the portion of consumer goods increased by roughly the same proportion, in line with Chinese rebalancing.

Based on analysis by CEPPII (2019)<sup>7</sup>, between 2007 and 2017, China's revealed comparative advantage increased sharply in telecommunications equipment, electrical apparatus and yarn fabrics, but declined in miscellaneous manufacturing, knitwear and clothing. Meanwhile, China's revealed comparative *dis*advantage (sectors where China ran a trade deficit) increased in travel services, transport, edible agricultural products (except cereals) and non-monetary gold.

<sup>7</sup> The Centre d'Études Prospectives et d'Informations Internationales (CEPII) calculates the revealed comparative advantage based on the sector's contribution to the overall trade balance. See <http://visualdata.cepii.fr/panorama/en/?country=China>.



**Figure 8: EU-China trade, selected member states (2002-17) (% of member state GDP)**



Source: World Bank WITS (<https://wits.worldbank.org/>).

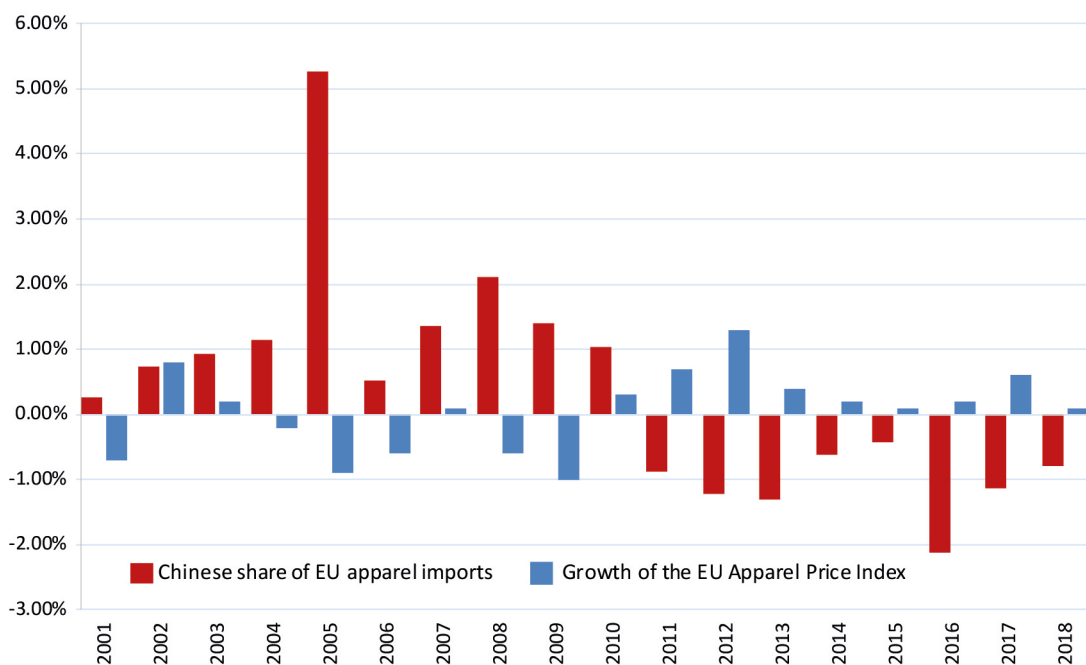
Figure 8 shows EU-China trade by member state for China’s largest trading partners in the EU. Imports into the Netherlands are overstated because of the so-called ‘Rotterdam effect’, as many goods destined for other EU countries arrive at the port of Rotterdam and other Dutch ports, inflating the Dutch share. Only Germany and Sweden have a trade surplus in goods with China at time of writing. In fact, in 2017, 44 percent of EU exports to China originated from Germany, almost as much as the next nine countries put together. The share of Germany’s gross exports of merchandise to China, expressed as a share of Germany’s GDP, amounts to 2.5 percent. This share is a little smaller than Japan’s and three times larger than those of most EU countries and of the United States.

The political discourse on trade policy tends to be preoccupied with exports and with the competition brought by imports. Numerous studies have examined the disruption brought on by trade, in particular by trade with China<sup>8</sup>. These effects have been felt most keenly in the United States, a hitherto open economy where social safety nets are weak. But the disruption has also been felt strongly in some EU sectors. For example, Utar (2014) found competition from China to have had a negative effect on employment, value-added and intangible assets in the Danish textile and clothing industry. Balsvik *et al* (2014) found that, in Norway, around 10 percent of the fall of manufacturing’s share of employment was driven by competition from China. However, no effect could be found for wages.

<sup>8</sup> For example, Acemoglu *et al* (2016) studied US labour markets and concluded that the growth in import penetration from China since 1999 led in the loss of 560,000 manufacturing jobs in the US up to 2011 (10 percent of the decline in US manufacturing jobs). More widely, taking into account indirect effects, Chinese imports throughout that period resulted in 2 million to 2.4 million workers losing their jobs. More generally, Bernard *et al* (2006) found higher plant closures in industries facing high levels of competition from low-wage countries. Autor (2018) studied commuting zones in the US, to show a strong relationship between the reduction in manufacturing employment and exposure to Chinese import competition. He concluded that transfer receipts for workers “rise by approximately \$6 per capita for every extra \$100 in local import exposure,” and called for improvements to trade adjustment programmes.

In contrast, the benefits that consumers derive from trade through increased competition, lower prices, improved quality and increased variety tend to attract little attention, even though economic theory suggests that they represent a very important source of gains<sup>9</sup>. As Paul Krugman has argued, the objective of engaging in international trade is to import, and exports are only a means to pay for imports. In the present era of global value chains, where the a large proportion of trade takes the form of parts and raw materials and machines, some of which are not produced in home markets but exclusively imported, imports have become essential for efficient production and not just for consumption. China's top exports to the European Union are telecommunications equipment, computer parts, baby carriages, electrical machinery, apparel and footwear. The inflow of these products from China has undoubtedly expanded the range available to EU consumers, while large quantities of intermediate goods or inputs have also been supplied at low prices, improving the productivity and international competitiveness of EU industries.

**Figure 9: Annual growth of the EU apparel price index (HICP, 2015 = 100) vs. the change in the share of EU apparel imports from China**



Source: Eurostat. Notes: Change in the share of EU apparel imports from China is displayed in percentage point, the annual average rate of change clothing and footwear HICP also in percentage (2015 = 100).

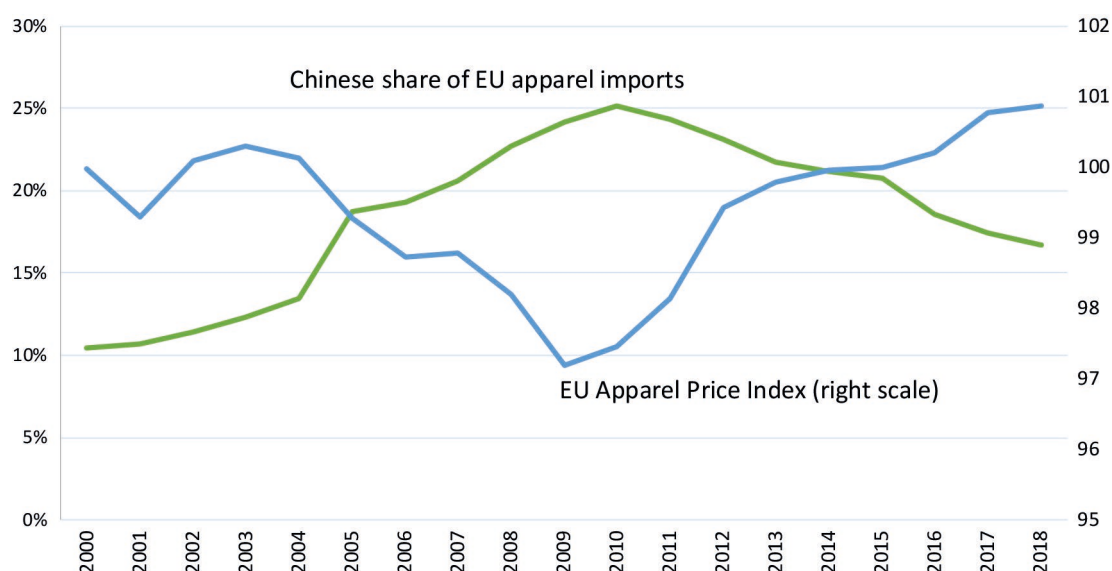
Chinese imports appear to have had a significant effect containing price rises faced by European consumers in some sectors. In line with the results obtained by Lau (2018) concerning the price impact of imports from China on the US apparel market, EU apparel imports from China have also been found to have helped retard EU apparel price rises<sup>10</sup>. Between 2003 and 2009, the annual growth rate of the EU apparel price index was almost always in the opposite direction to the annual change in the Chinese share of EU apparel imports. This can be seen in Figures 9 and 10. During that period, whenever the

<sup>9</sup> Few studies have focused on this issue. Berlingieri *et al* (2018) studied the impact of EU trade agreements between 1993 and 2013, finding them to (on average) increase product quality by 7 percent. Bloom *et al* (2011) analysed the impact of Chinese competition using a panel of 5,000 firms in 12 European countries between 1996-2007, finding it caused faster technological change (in the form of both technology upgrades within firms and reallocation of labour towards more technologically-advanced firms), and thus productivity growth.

<sup>10</sup> The term apparel and numbers represented in the charts include apparel and footwear.

Chinese share of EU apparel imports went up, the EU apparel price index came down, and vice versa. The share of EU apparel imports from China peaked in 2010 at 25 percent. Since then, the observed effect has begun to be offset by the rise in the share of EU apparel imports from other countries (eg Association of Southeast Asian Nations members).

**Figure 10: EU apparel price index (2015 = 100) vs. the share of EU apparel imports from China**



Source: Eurostat. Notes: Level of EU Apparel Price Index (2015 = 100). Share of EU apparel imports from China is displayed in percentages.

### 3 Tariff and non-tariff barriers

As shown in the previous section, EU-China trade has grown rapidly in the past two decades. However, there is still abundant potential for growth. Recent progress has been hindered by a host of tariff and non-tariff barriers.

Although Chinese exporters have to contend with high EU tariffs and various trade defence measures in some sensitive sectors, the tariffs faced by EU firms in China are much more substantial and cover a wider range of sectors. These tariffs are far higher than those faced by EU firms in the United States or Japan, for example. The average effectively applied tariff for EU products entering the US in 2017 was 1.4 percent, and for EU products entering Japan 2 percent. This stood in stark contrast to the 8.75 percent faced in China<sup>11</sup>. Considering the EU exported \$200 billion worth of goods to China in 2018, this implies that firms exporting from the EU to China paid about \$17.5 billion in tariffs. Tariffs paid by EU firms last year to Mercosur, with which the EU agreed a trade deal in June 2019, represent about one quarter of those paid to China.

Vehicle and vehicle parts, which were the largest product category of EU exports to China in 2017, face an effectively applied tariff of nearly 20 percent. From EU automobile exporters alone, Chinese customs collected \$5.49 billion dollars in tariffs in 2017. Nevertheless, in 2018, China's state council adopted measures to reduce vehicle tariffs from 25 percent to an average of 13.8 percent<sup>12</sup>. This represented a

<sup>11</sup> Authors' calculation based on data from the World Bank WITS database.

<sup>12</sup> China's Customs Tariff Commission made the announcement on 22 May 2018, see [in Chinese] [http://www.gov.cn/xinwen/2018-05/22/content\\_5292720.htm](http://www.gov.cn/xinwen/2018-05/22/content_5292720.htm).

significant step forward and a new opportunity for European car manufacturers to profit from China's expanding automobile market.

Chinese exporters face lower tariffs entering the EU market in most sectors. In 2017, the weighted average of effectively applied tariffs on Chinese products into the EU was 3.6 percent, less than half of that charged on EU products entering China. In total, Chinese firms exporting to the EU paid about \$14.4 billion in tariffs. China's top two exports to the EU in 2017, machinery and electronic equipment, which account for over 50 percent of total Chinese exports to the EU, face effectively applied tariffs of just 1.2 percent and 0.8 percent respectively. China's apparel and footwear exports to the EU face a tariff of over 11 percent. China is thought to be the primary price-setter in the apparel and footwear markets. These tariffs also apply to other WTO members with which the EU does not have a trade agreement, which makes them much more likely to be mostly passed on to European consumers.

Despite tariff barriers, there has been progress in the China-EU trade relationship, as shown by the lowered tariffs on EU exports of automobiles and parts. Since 2018, China has reduced the tariffs applied to its imports of luxury goods and apparel products, benefiting France, Italy and other EU members<sup>13</sup>. Amidst China-US trade tensions, China's elevated tariff schedule for US exports means more opportunities for European firms entering the Chinese market<sup>14</sup>.

But tariffs are not the whole story in the EU-China trade relationship. In many ways non-tariff barriers (NTBs) play a larger role. NTBs include restrictions on government procurement, import quotas for agricultural products and various forms of subsidisation. NTBs also include trade remedies, which, while they can be applied in ways that are entirely WTO compatible, are often suspected of being a form of protectionism. The European Commission counts 18 ongoing trade defence measures adopted by China against EU exports<sup>15</sup>. China's Trade Remedy Investigation Bureau (TRIB) regularly carries out anti-dumping and anti-subsidy investigations into EU exports, ranging from intermediate products to chemicals, although the magnitude of EU infringement is certainly small<sup>16</sup>.

Specific measures hinder trade flows between the EU and China. For example, the EU's agricultural exports to China – which include beverages, dairy and various higher value added varieties – have traditionally faced NTBs in the form of product certification, labelling standards, import approval requirements and customs clearance delays (Niemi and Huan-Niemi, 2007). Although China has progressively reduced these NTBs, China's domestic agricultural standards and regional variations in customs procedures have consistently impeded agricultural trade. To be sure, the EU's subsidies and barriers to agricultural imports are also substantial. However, since China is a big net importer of

<sup>13</sup> The positive consequences of trade liberalisation are seldom disputed, as many studies have shown. Nicita (2009) found tariff liberalisation to have increased households' purchasing power following trade liberalisation in Mexico in the 1990s. Similarly in India, De Loecker *et al* (2016) showed that prices and marginal costs of production fell significantly. Amiti *et al* (2017) found that between 2000 and 2006, China's accession to the WTO contributed to a 46 percent decrease in the import price index in the US. Lastly, Cernat *et al* (2018) estimated that EU households would have saved annually around €60 billion in import consumption if tariffs were reduced to the pre-Uruguay round level.

<sup>14</sup> A point made by García-Herrero (2019b).

<sup>15</sup> See <http://ec.europa.eu/trade/policy/accessing-markets/trade-defence/actions-against-exports-from-the-eu/>.

<sup>16</sup> For more detailed information, see

[https://trade.ec.europa.eu/doclib/docs/2010/september/tradoc\\_146659.pdf](https://trade.ec.europa.eu/doclib/docs/2010/september/tradoc_146659.pdf) and <http://trade.ec.europa.eu/actions-against-eu-exporters/cases/index.cfm>.

agricultural products, and its agricultural exports are generally not competitive on the EU market, those barriers are unlikely to have much effect on trade between the two blocs<sup>17</sup>.

Public procurement procedures represent another major impediment for European businesses in China: Chinese regulations are fragmented, inconsistent and unevenly implemented. The EU Chamber of Commerce in China (2011) estimated that the resulting efficiency and innovation losses represent a missed opportunity the size of the South Korean economy for European businesses in China.

Different ministries and different levels of government in China impose regulations on public procurement, with a heavy preference for local firms and emphasis on 'indigenous innovation'. Despite an undertaking given in 2001 when it joined the WTO, China has not joined the WTO Government Procurement Agreement, a multilateral agreement between 40 WTO member countries to open up their non-defence public procurement markets to each other. At each step in the public procurement process, European companies face a lack of transparency, unclear evaluation criteria and non-reciprocal market access.

To a lesser extent, the EU adopts plenty of its own trade defence measures (TDIs) to oppose ostensibly unfair trade practices, and China is often the target. The EU has 20 ongoing anti-dumping and anti-subsidy investigations targeted against Chinese exports to the EU<sup>18</sup>. In certain product categories, the EU imposes quotas on imports from China. For instance, the EU's import quota on automotive grade HDG (hot-dip galvanised) steel from China in 2019 was filled by the end of June.

China's excess production capacities also impact some industries in the EU, most notably steel. As a result of the EU's deployment of TDIs, steel now represents less than one percent of total Chinese exports to the EU. As of August 2019, the European Union had 16 trade remedy measures (through anti-dumping duties and countervailing duties) that provided relief for domestic steel industries against steel mill products from China (International Trade Administration, 2019).

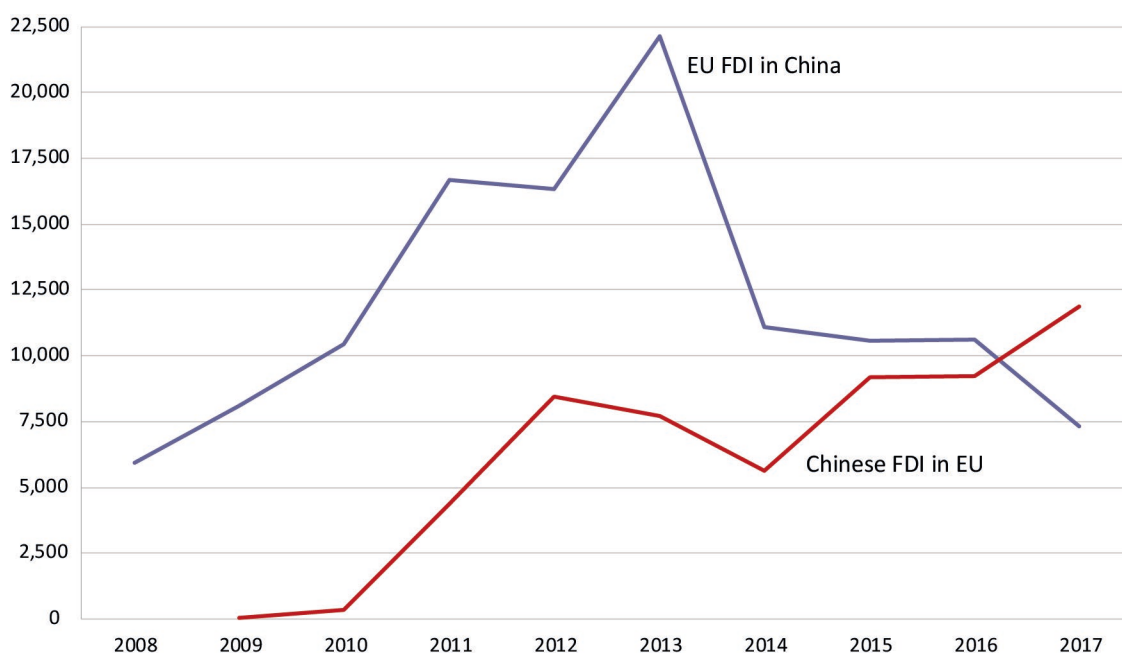
#### **4 FDI flows**

Foreign direct investment (FDI) flows between the EU and China are closely related to trade, complementing trade because FDI results in the development of marketing networks, provides financial and transport services and leads to production with a view to selling in global markets. FDI flows can also substitute for trade, for example when investors establish facilities to produce and sell in the same market. Furthermore, the purchase by investors of controlling interests in competitors or suppliers, including raw materials, often fosters global or regional value chains that tend to stimulate trade. Not surprisingly, as trade between the EU and China has surged, FDI has also increased. However, bilateral FDI flows remain small in relation to the size of both economies and have been volatile (Figure 11).

<sup>17</sup> In November 2019, China agreed to recognise a number of EU Geographic Indications. See [https://ec.europa.eu/commission/presscorner/detail/en/IP\\_19\\_6200](https://ec.europa.eu/commission/presscorner/detail/en/IP_19_6200).

<sup>18</sup> See <https://trade.ec.europa.eu/tdi/>.

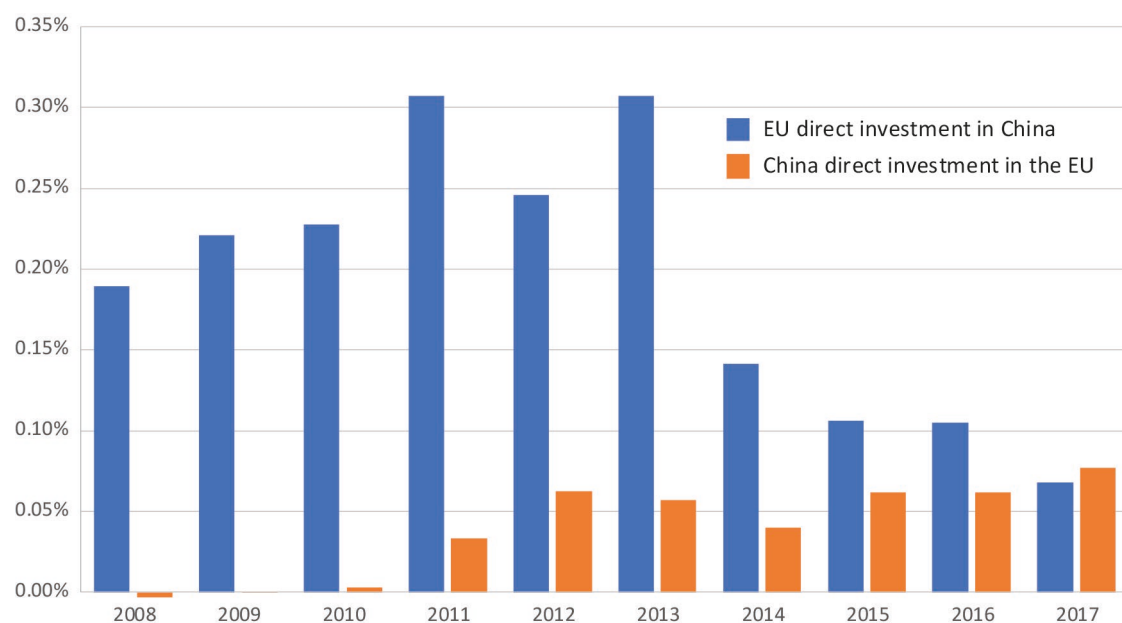
**Figure 11: Annual China-EU direct investment flows (€ millions)**



Source: Eurostat.

Still, from 2008 to 2017, the stock of EU FDI in China grew from €54 billion to €178 billion, an increase of 225 percent. Meanwhile, the stock of Chinese FDI in the EU has risen nearly tenfold during the last decade, reaching €59 billion in 2017.

**Figure 12: Annual EU-China investment flows as a share of recipient's GDP (% of GDP)**



Source: Bruegel based on data from Eurostat, BEA, FRED, World Bank, OFX.

European FDI in China has fallen in recent years, and European players have complained of the many obstacles faced in China where investor protection is poor and market access highly uneven and sometimes arbitrary. A key concern has been joint venture requirements in many sectors. These have

often involved transfers of intellectual property to Chinese counterparts, making investment in Chinese operations less attractive. Increased competition from Chinese companies, and rising wages, have also reduced incentives to invest in China (Garcia Herrero and Xu, 2019).

Nevertheless, a fair amount of FDI into China is thought to be re-routed through other countries that enjoy more favourable investment relations (and as such provide greater investor protection). Although concrete data on this is lacking, Garcia Herrero and Xu (2019) found around 70 percent of FDI into China came from Hong Kong in recent quarters, up from 35 percent in 2003. Much of this is thought to originate from alternative Ultimate Investing Countries (UIC).

Amidst a general downturn in Chinese overseas investments, which also affected the United States, Chinese FDI in Europe declined by 40 percent between 2017 and 2018 (Hanemann *et al*, 2019). A review of China's Ministry of Commerce publications and other sources, such as UNCTAD's investment reports, suggests that total Chinese FDI outflows have more recently begun to decrease because of Beijing's tightening of capital controls and domestic credit, plus stricter investment screening procedures implemented by major EU countries.

The two-way flows still represent only a tiny fraction of total inbound FDI in China and the EU, with Chinese FDI in the EU representing about 4 percent of total FDI in the EU in 2017, and EU FDI accounting for only about 5 percent in the opposite direction. The flows of FDI are only a minuscule – almost imperceptible – part of total domestic investment in the EU, and are smaller still as a share of domestic investment in China. Sectorally, manufacturing heavily dominated EU FDI in China in the early 2000s, but the trend is gradually shifting towards services. China, meanwhile, has significantly increased its investment in strategic sectors, with a specific focus on the acquisition of technology. This is partially policy driven. Acquiring foreign currency funding has recently proven difficult without government approval which partially depends on the strategic value of the proposed investment.

Within the EU, Germany is the biggest provider of FDI to China, with the Netherlands and the Nordics (Sweden and Denmark together) claiming second and third place respectively. Germany and the Netherlands have also been the main recipients of Chinese FDI, which, as mentioned already, has declined recently. These bilateral FDI flows may show a misleading picture. For example, flows of FDI to and from the Netherlands are affected by a large number of Special Purpose Entities (SPEs) that act as 'conduits' of FDI to other countries, and more generally, re-routing takes place within the EU.

Chinese FDI in Greece and Portugal and non-euro area countries in central and eastern Europe (Bulgaria, the Czech Republic, Croatia, Hungary, Poland and Romania) has spiked significantly ever since 2014 from a low base. All of these countries signed memorandums of understanding with China as part of the Belt and Road Initiative (BRI).

FDI flows from the US into China were of similar magnitude to those of the EU to China in 2016, but the US received about twice as much as the EU in Chinese FDI. Here again, statistics relating to bilateral FDI flows should be treated with caution. Much of the FDI into and out of China moves through third parties, especially Hong Kong and Singapore, with which China has bilateral investment agreements and where the rights of the parties are more formally established and more easily enforced.

From 2013 to 2017, China earned €8.3 billion from its investments in Europe, whereas the EU earned €81 billion from investments in China, according to Eurostat. The top beneficiaries were Germany, the Netherlands and France. EU firms have enjoyed high rates of return on their investments: between 2013 and 2017, the average annual rate of return for EU direct investments in China was 10.1 percent. This rate of return is higher than investments in other countries such as Japan (8.9 percent), India (7.2 percent), Russia (6.8 percent) and the United States (2.9 percent). On the other hand, annual returns on

Chinese direct investments in the EU averaged 4.2 percent during this period, not significantly different to the returns on investments in the United States.

In April 2019, a new foreign investment screening framework took effect in the EU, which aims to increase the robustness of the process. Screening is done primarily at member-state level, with EU countries having the final word. Greater scrutiny of the Chinese commercial presence in Europe would pose ongoing challenges to Chinese investors in Europe in the future<sup>19</sup>.

## 5 Portfolio & banking flows

Portfolio and banking flows between the EU and China are comparatively small. Portfolio investment (PI) flows, according to the European Commission, refer to any cross-border transactions in equity or debt instruments that cannot be considered direct investment (as they represent a stake of less than 10 percent in a particular entity) or reserve assets. Other Investment (OI) flows include the lending and borrowing activities of international banks.

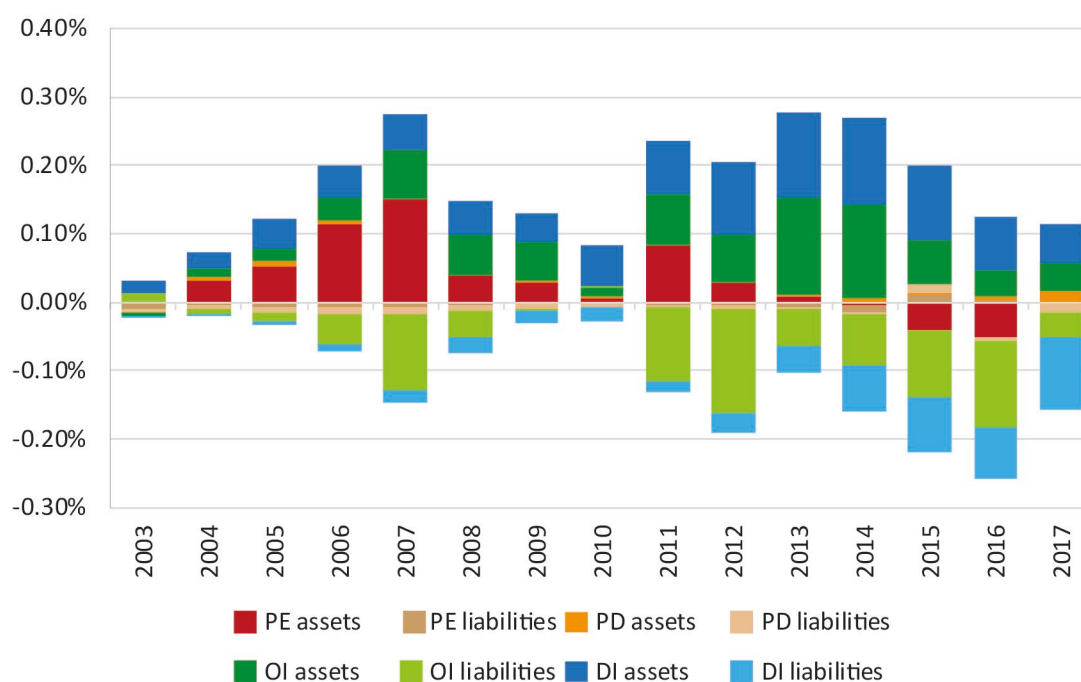
PI and OI flows between the EU and China remain small given the sizes of the two economies. The estimated EU stocks of gross Chinese equity PI and debt PI are €126 billion and €23 billion respectively. In contrast, the EU's stocks of US equity PI and debt PI are €2.3 trillion and €2 trillion. At the same time, while the EU's stock of Chinese OI is €154 billion, that of US OI is almost €2 trillion.

With that in mind, several interesting features stand out in relation to the composition of the flows (Figure 13). Firstly, OI flows rose steadily between 2009 and 2016. They also represented the bulk of the heavy increase in net financial outflow from China between 2014 and 2016 (during 2015-16 this outflow represented more than 4 percent of Chinese GDP). This shift in balance is shown in Figure 13, which shows both the increase in Chinese OI inflows into the EU and the fall in EU outflows to China during this period. The surge in Chinese net outflow was initially driven by the reduction in Chinese assets held by foreigners. It was then sustained by the increase in foreign assets held by Chinese residents, aided by the 2015 episode of renminbi depreciation that spurred the rise in Chinese saving exports (Claeys *et al*, 2017). This strong net outflow had largely subsided by 2017 causing a fall in gross OI flows evident in Figure 13. This fall has been driven by a reduction in external lending: the shrinking current account is constraining financing in dollars and risk aversion is rising (Richet, 2019). The impact of capital controls introduced to limit the outflow was more effective from 2017.

<sup>19</sup> For details, see [https://europa.eu/rapid/press-release\\_IP-19-2088\\_en.htm](https://europa.eu/rapid/press-release_IP-19-2088_en.htm).



**Figure 13: Chinese gross flows to EU countries by category, % of EU GDP**



Source: Finflows (Nardo *et al*, 2017). Note: PE = portfolio equity, PD = portfolio debt, OI = other investment, DI = direct investment.

Equity portfolio investment flows have shifted significantly. As recently as 2007, outflows from the EU into China were more than 30 times the inflows from China into the EU. Now, inflows from China into the EU predominate. A partial explanation for this change is China's 2015 industrial strategy, *Made in China 2025* (MIC2025), which has led to the purchase of strategic stakes in European companies. While most this is taking place through FDI, some influence on portfolio equity flows is also apparent. Additionally, while portfolio debt makes up a much smaller share of flows, its geographical reach has expanded beyond financial centres and the UK, with growing flows from some of the euro area's core economies (Germany, France, Italy and the Netherlands).

Finally, the evolution of flows between China and non-euro area central and eastern European countries (Bulgaria, the Czech Republic, Croatia, Hungary, Poland and Romania) has attracted attention. This group displays significantly negative net bilateral flows because of large inflows from China. All of these countries have been part of the BRI 16+1 cooperation platform since 2012, although the spike in inflows began in 2015. It is unsurprising that these countries receive large flows of FDI from China because large infrastructure projects are at the core of the BRI. The growth in other investment flows is more striking. We would expect the majority of these to be banking flows<sup>20</sup>, yet this growth in Chinese banking activity in the region has been largely unexplored by the literature.

<sup>20</sup> As per the European Commission's Finflows database: <https://ec.europa.eu/jrc/en/publication/finflows-database-bilateral-financial-investment-stocks-and-flows> (Nardo *et al*, 2017).

## 6 Movement of people

Movement of people between the EU and China is an important part of the relationship. Such exchanges have played a vastly augmented role in the last decade despite cumbersome visa requirements and tight restrictions on immigration. Most notably, China has become the world's largest travel market in terms of outbound travel and expenditure, and Europe has become the second most popular continent for Chinese tourists (after Asia), attracting 13 percent of China's outbound visitors.

The number of Schengen visa applications made from China (more than 95 percent are approved) rose from 825,511 in 2010 to 2.9 million in 2018, an annual increase of 12.37 percent. More than 600 flights connect Europe and China every week, bringing 6 million Chinese visitors to Europe in 2017. Chinese and EU leaders branded 2018 the EU-China Tourism Year. The EU countries receiving the greatest number of Chinese tourists are France, Germany, Italy, Spain and the UK, creating stable incomes and jobs in many European cities.

EU residents can visit 19 Chinese cities for up to 72 hours through a visa-free transit arrangement, or can apply for a Chinese tourist visa. In 2016, EU citizens made 2.1 million trips to China, a 16 percent increase from 2012. In the same year, 17.3 percent of inbound tourist trips by foreigners into China were from Europe, compared to 67.5 percent from Asia and 10.7 percent from America. The EU is a net exporter of travel services to China: in 2016, EU residents spent nearly €3 billion in China, while Chinese visitors to the EU spent nearly €7 billion.

In addition, the largest group of non-EU students in the EU comes from China. Affordable higher education, university partnerships and growing connectivity between China and the EU have made studying in the EU attractive for Chinese students. In 2018, more than 100,000 Chinese students were studying in the UK, generating tens of billions in revenues for the British economy<sup>21</sup>. Amid ongoing US-China tensions, the number of Chinese applicants to UK universities increased by 30 percent in 2019<sup>22</sup>. Germany (32,268) and France (28,760) are also top destinations for Chinese students, benefiting from similar growth trends.

Europeans studying in China are fewer. A total of 71,319 European students (30 percent of whom are Russian) studied in China in 2016. This represents only 16 percent of the foreign student population in China. Of them, 10,414 students were French, followed by Germans (8,145), British (6,217) and Italians (5,584).

Besides these short-term exchanges, Chinese immigrants have long been present throughout Europe. It was estimated in 2011 that there were 2.15 million Chinese immigrants in Europe<sup>23</sup>, with the UK, France and Italy in particular hosting large Chinese populations.

It is important to note that not all Chinese travel expenditure as measured by official statistics takes the form of actual purchases of travel services. As capital controls have tightened in China, tourism might have become a conduit for capital flight (Wong, 2017). It is impossible to measure the extent of this phenomenon, but it is worth noting that as capital controls were tightened, tourism expenditure

<sup>21</sup> *Financial Express* (2017) 'International students generate over 25 bn pounds to UK economy: Study', 6 March, available at <https://www.financialexpress.com/world-news/international-students-generate-over-25-bn-pounds-to-uk-economy-study/577421/>.

<sup>22</sup> Sally Weale (2019) 'Chinese students' applications to UK universities up by 30%', *The Guardian*, 11 July, available at <https://www.theguardian.com/education/2019/jul/11/chinese-students-applications-to-uk-universities-up-by-30>.

<sup>23</sup> See Gui (2011) and <http://www.culturaldiplomacy.org/academy/index.php?chinese-diaspora>.

rose from 6.1 percent of total imports in 2013 to 12.9 percent in 2016 (World Bank World Development Indicators).

## **7 China, the EU and the US**

China and the EU have an extensive and growing economic relationship, as do China and the United States, present tensions notwithstanding. However, those bilateral relationships pale in comparison to the intensity of exchange between the EU and the United States. China is the smaller economy of the three expressed in market exchange rates (though it is the biggest expressed in PPP-adjusted exchange rates), and the deep EU-US relationship is long-standing, while relations with China only took off in the 1980s following the opening up of China. But the barriers to a deeper relationship between China and the EU remain far higher than those between the EU and the United States.

The EU is the US's premier trading partner and vice versa: trade between them reached \$1.3 trillion in 2018. While goods make up most of this (\$807 billion), trade in services is also huge, at \$452 billion in 2018. Trade between the two economies is fairly balanced: while the EU has a trade surplus in goods of \$109 billion with the US, the US has a services trade surplus with the EU of \$60 billion. Meanwhile, EU-China trade and US-China trade are each worth something in the vicinity of \$750 billion, about 40 percent smaller than that between the EU and the US. Moreover, trade with China consists predominantly of trade in goods.

Closer ties between the US and China have been hindered by obstacles similar to those experienced by Europeans: chiefly high tariff and non-tariff barriers, restrictions on where and how to invest, unfair competition from state entities and political interference in the private sector, and poor protection of intellectual property rights. The United States' large trade deficit with China fans these flames, and since 2017, US-China trade frictions have deteriorated into a trade war. The tensions are exacerbated by open geopolitical competition and security concerns.

Economic relations between the EU and the US appear calm in contrast, but they have not been easy. The proposed Transatlantic Trade and Investment Partnership (TTIP) encountered heavy opposition on both sides of the Atlantic even before the Trump Administration. The EU's trade surplus with the US is a source of friction, and the imposition by the US of tariffs on aluminium and steel, and the threat to do so on automobiles, invoking national security, has been hugely controversial. The Trump Administration's support for Brexit has also irked Europeans. Long-standing trade disputes, most notably the Boeing-Airbus case, are being litigated at the WTO. Americans continue to challenge Europeans over the extent of their protection and subsidisation of agriculture and their high tariffs on cars.

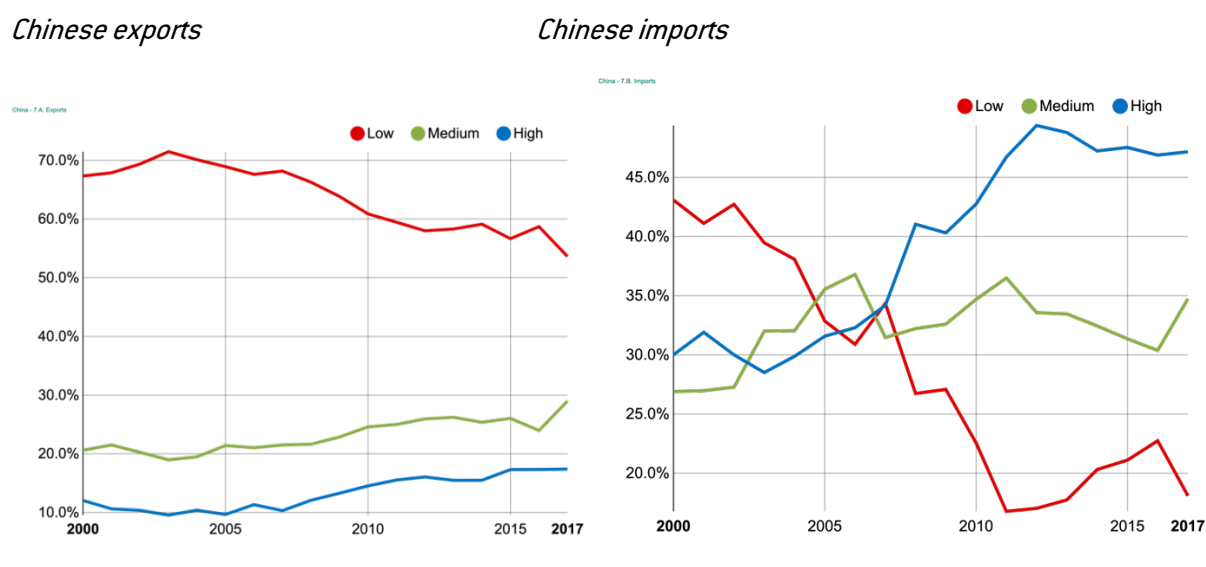
It is difficult to be precise on how much greater trade between the EU and China (or between the US and China) could be if China's system and its level of protection conformed more closely to those of the EU and the US. A European Central Bank study (Bussière and Schnatz, 2006) used a gravity model of trade to suggest that China is already fairly well integrated in international markets, especially with many EU countries and North America (among others). Trade between the US and the EU is so intense in part because it is heavily intra-industry, in sectors ranging from aircraft to car parts and components to pharmaceuticals to financial and professional services, relying on skills, technology and product differentiation, whereas trade with China has historically relied more on the latter's labour cost advantage. Thus, in 2017, 81 percent of China's trade was one-way, ie trade that is inter-industry and where exports and imports are not in the same category, whereas 43 percent of US trade and 39 percent of Germany's trade was identified as one-way (CEPII, 2019).

Much attention has been paid to the increased value of China's exports, but the transformation of China's imports towards higher value items is even more pronounced as Figure 14 shows (CEPII, 2019). This implies that, while China is competing more directly with advanced nations on world markets, it is also becoming a far more important market for their specialised products and services.

On balance, it is difficult to escape the conclusion that trade volumes between the EU and China (and the US and China) could be far closer to those between the US and the EU were barriers in China much lower. As Chinese living standards rise, Chinese consumers demand more variety and China engages more in intra-industry trade, trade volumes between the EU and China are likely to reach similar orders of magnitude to those between the EU and the US.

The current disparity is even greater in the flow of foreign direct investment. The stock of US FDI in the EU was almost \$3 trillion in 2017, while the stock of EU FDI in the US was \$2.2 trillion. This is more than ten times the stock of EU or US FDI in China: \$196 billion (EU) and \$101 billion (US). The Chinese stock of European and American FDI is even smaller: Chinese stock of EU FDI is \$82 billion, and the stock of US FDI is \$39 billion. That said, these values have grown substantially in recent years, in 2001 the EU stock of Chinese FDI was \$42 billion, while the US stock of Chinese FDI stock was \$12 billion.

**Figure 14: Breakdown of Chinese manufactured exports and imports by unit value range, in % of total of exports and imports of manufactured goods, 2000-2017 evolution**



Source: CEPII, CHELEM database.

How can these large differences be explained? In addition to the relatively recent vintage of FDI in China, one can point to the long negative list of sectors where foreigners cannot invest in China and to the joint venture/technology transfer requirements in sectors where they can. The absence of a bilateral investment treaty between the US and China means that both sides have less protection (national treatment and dispute settlement procedures) than they would otherwise. This encourages American companies to invest through their overseas subsidiaries. The re-routing of investment through Hong Kong is likely to be more significant for the US than the EU given the total absence of a treaty. This almost certainly contributes to undercounting of US investment in China.

The absence of a Bilateral Investment Treaty (BIT) between the EU and China is less of a problem because of long-dated investment agreements between EU member states and China. China's direct investment in the EU and US may have been held back by various forms of capital controls in China

until recently. Moreover, insofar as Chinese firms relied heavily on low labour costs, a situation that is changing rapidly, their incentives to set up production in high-income countries might have been limited. It is difficult to escape the conclusion that two-way FDI flows between China and the EU (and between China and the US) could be substantially larger were barriers lower. As Chinese labour costs continue to rise and Chinese consumers demand more variety, two way-flows of FDI between the EU and China are very likely to increase.

## 8 Institutional framework

Despite their mutual importance as trading partners, institutional arrangements governing bilateral exchanges between China and the EU remain limited. There is no free trade agreement between China and the EU, and the likelihood of embarking on such negotiations appears slim at present. As already mentioned, several EU member states concluded investment treaties with China long ago but these treaties were designed to offer investors national treatment and judicial remedy (ie protection) and do not include market-access provisions. The European Union, which now has authority to negotiate on investment, is engaged in negotiation of a deep and comprehensive investment treaty with China, intended to cover issues including market access and joint venture requirements, but these negotiations have proved slow and difficult. The parties recently committed to conclude them by the end of 2020.

### Box 1: What can the EU learn from the China-Switzerland Trade Agreement?

China is the third-largest buyer of Swiss industrial goods after the EU and US. After four years of consultation and two years of negotiation, a bilateral free trade agreement (FTA) between China and Switzerland was signed in July 2013. The FTA dismantled tariffs fully or partially, either immediately or following a transition period, for nearly all goods. The agreement is comprehensive. For example, it sharpens General Agreement on Trade in Services (GATS) disciplines in services, strengthens intellectual property protection, and establishes clear rules of origin, trade remedies and transparency in government procurement. It also provides for a monitoring and cooperation mechanism that can improve the agreement, including by providing dispute settlement mechanisms.

Though the main aim of the FTA is to establish preferential trade relations between Switzerland and China, it also promotes cooperation in fields including science, innovation, research, education and culture. A three-year currency swap agreement was also established between the People's Bank of China and the Swiss National Bank in July 2014, while in January 2015, Zurich was designated one of only a handful of world cities to be a trading hub for the renminbi.

Trade volume and indicator data illustrates how bilateral trade between Switzerland and China has deepened since signing the FTA. The share of Switzerland's exports to China out of total exports increased from 5.8 percent in 2013 to 8.2 percent in 2017. Switzerland's trade intensity index (this index assigns a score of 100 to countries with a world average level of trade) with China similarly increased from 71 in 2013 to 93 in 2018. However, Switzerland's exports to China are highly volatile, since gold and jewellery exports represent about half of Switzerland's exports to China. Pharmaceutical products, which represented 16 percent of Switzerland's exports to China in 2017, have seen rapid annual growth of 22 percent since signing the FTA. Interestingly, China's exports to Switzerland have not increased significantly since the FTA was put in place. China's top five exports to Switzerland, including chemicals, machinery and apparel, accounted for more than 62 percent of total Chinese exports to Switzerland in 2017, and only grew at a modest 1.8 percent annually between 2013 and 2017. The trade intensity index similarly has remained very low, at around 9.3.

Switzerland's non-alignment in foreign policy clearly facilitated its closer ties with China. China's opening toward Switzerland is part of a strategy to penetrate European markets, while Switzerland has been eager to capture the benefits of preferential access to the huge Chinese market and of establishing its presence ahead of the EU. Proponents of the agreement in Switzerland have described the deal as the most significant agreement since the 1972 FTA with the EU. Although some points of contention existed in Switzerland, as they do in the EU, most notably around human rights abuses and labour practices, the Swiss have adopted a pragmatic approach. For example, the Swiss insisted on including a bilateral Agreement on Labour and Employment that addressed some of their concerns.

A discussion of geopolitical tensions between China and the European Union, which are part of the reason for the paucity of institutional arrangements to govern the China-EU economic relationship, is outside the scope of this paper. It is clear, however, that even though the EU is not locked in a global power struggle with China, the escalating competition between China and the United States, Europe's historical ally, have made China-EU relations more complicated. A March 2019 communication from the European Commission referred to China as a *"systemic rival promoting alternative models of governance"* (European Commission and High Representative, 2019).

China's Belt and Road Initiative (BRI) and the 16+1 framework that governs BRI cooperation between China and 16 central and eastern European countries (11 of which are EU members) are cases in point. Baltensperger and Dadush (2019) addressed the BRI's potential benefits and limitations, while a recent paper by the European Parliament Research Service (EPRS, 2017) concluded that the initiative has had limited success and has not resulted in institutions (formal and informal) conducive to closer ties. Many questions have been raised about the geostrategic implications of some of China's infrastructure investments in Europe. The Chinese acquisition of a stake in eight major European maritime ports (more than two thirds of goods transported through Europe arrive by sea), including a 35-year lease on the Port of Piraeus in Greece<sup>24</sup> have raised concern, as has sustainability of the debt incurred by borrowers from Chinese entities, even though those most at risk are outside the EU<sup>25</sup>.

Beyond geopolitical concerns, there are other systemic or quasi-systemic obstacles to deepening the EU-China relationship, and these obstacles often contribute to the tensions. The obstacles stem from the different economic structure of the Chinese system and the pervasive role of the state. When analysed under the norms and explicit rules of the international liberal system, these features are believed to have resulted in unfair practices that have given Chinese entities an artificial competitive advantage in global markets. In 2018, without explicitly mentioning China, the EU, US and Japanese trade ministers developed a trilateral framework intended to deal with these issues under the umbrella of WTO reform<sup>26</sup>. Various proposals have been made for WTO reform to facilitate Chinese integration (Mavroidis and Sapir, 2019). At the time of China's accession to the WTO, there was a generalised belief that China would gradually reform its economic structure to better conform to Western standards and those of the international rules-based system. That said, some serious critics viewed China as unprepared to become a WTO member and considered that China could do significant damage to the

<sup>24</sup> Pandya and Tagliapietra (2018) reported that the Greek port's profits reportedly rose by 147 percent in 2018, while many foreign companies, including HP and Sony, set-up distribution centres there.

<sup>25</sup> Hurley *et al* (2018) classified eight of the 68 potential BRI borrowers as under a *"particular risk of debt distress"*, although none of these are EU countries (Montenegro is the only European country included). China's opaque and variable financing terms and case-by-case attitude to distress, as well as the lack of adherence to multilateral standards of debt sustainability, complicate the situation. The Rhodium Group (Kratz *et al*, 2019) further reviewed this issue, concluding that while debt renegotiations are frequent, Chinese leverage in these investments is limited, and renegotiation often results in more balanced terms.

<sup>26</sup> See [https://eeas.europa.eu/regions/asia/51178/joint-statement-trilateral-meeting-trade-ministers-united-states-japan-and-european-union\\_en](https://eeas.europa.eu/regions/asia/51178/joint-statement-trilateral-meeting-trade-ministers-united-states-japan-and-european-union_en).

way global trade is conducted [for example, Hufbauer, 1998]. While some market-oriented reforms were carried out during the early 2000s (which helped deepen trade and investment ties) the overall consensus is that China has little intention of adopting Western practices in many areas and if anything has recently been moving in the opposite direction.

An EU Chamber of Commerce in China survey showed that 20 percent of respondents were compelled to agree to technology transfers in 2018 (10 percent in 2017). Strategic industries were more affected (30 percent of chemical and petroleum firms, 28 percent of medical firms and 27 percent of pharmaceutical firms). Furthermore, S&P Global Ratings shows that China relies heavily on foreign technology, with more than 50 percent of technology sector suppliers from overseas. In addition, the EU's annual report on customs checks at its borders shows China as the number one source of goods that infringe intellectual property rights, despite the EU-China action plan on customs cooperation in IPR matters<sup>27</sup>. Moreover, the EU has filed a complaint at the WTO claiming China's TIER (regulation on technology import and export) is incompatible with the WTO TRIPs agreement (Trade-Related Aspects of Intellectual Property Rights)<sup>28</sup>. These various concerns relate to technological competition from China, which is expected to increase<sup>29</sup>.

More than two decades ago, observers noted the possible harm state-owned enterprises (SOEs) could cause to international trading. While SOEs exist around the world, Chinese SOEs are large enough to distort international markets and primarily pursue the Chinese government's strategic objectives, rather than only or mainly the correction of market failures. That said, the number of SOEs has substantially fallen, although this might have increased the size of, and support received by, the remaining ones [Garcia-Herrero and Xu, 2017].

Additional distortion is caused by the state support received by Chinese private companies, through the provision of direct and indirect benefits that increase the competitiveness of their products in international markets. The purpose of these is also often strategic. China is clear in its desire to develop national champions in key industries identified in five-year economic policy plans; technology currently plays a bigger role, whereas manufacturing used to dominate. This subsidisation is often opaque and hard to assess externally. It includes preferential licenses, indirect provision of cheaper credit and even the encouragement and facilitation of mergers and acquisitions. The April 2019 EU-China Summit addressed this and included a memorandum of understanding on state aid and unfair competition to tackle distortions. The need to strengthen WTO rules in this area was also emphasised<sup>30</sup>.

Finally, lower environmental and labour standards in China present both a moral dilemma for the EU and an economic one. This has been a prevalent argument against a comprehensive trade agreement, as the EU would be importing those inferior standards and providing China with a competitive advantage because of the differential relative to European standards. Furthermore, even when operating in China, according to European companies, Chinese environmental regulation is selectively enforced to discriminate against foreign players [EU Chamber of Commerce in China, 2017]. Nevertheless, China has recently increased its climate focus and the Environmental Protection Law which came into effect

<sup>27</sup> Available at [https://ec.europa.eu/taxation\\_customs/business/customs-controls/counterfeit-piracy-other-ipr-violations/eu-china-cooperation-ipr\\_en](https://ec.europa.eu/taxation_customs/business/customs-controls/counterfeit-piracy-other-ipr-violations/eu-china-cooperation-ipr_en).

<sup>28</sup> See [http://trade.ec.europa.eu/doclib/docs/2018/june/tradoc\\_156910.pdf](http://trade.ec.europa.eu/doclib/docs/2018/june/tradoc_156910.pdf)

<sup>29</sup> MERICS (Shi-Kupfer and Ohlberg, 2019) address China's path to becoming global leader in digital technology, facilitated by coordination and ambitious government policy. The authors highlight the loss of European competitiveness in this field, heightened by Chinese takeover of European companies. They further point out possible security risks and call on the EU and member state governments to promptly focus on the integration and strength of the EU digital single market.

<sup>30</sup> See [https://europa.eu/rapid/press-release\\_IP-19-2055\\_en.htm](https://europa.eu/rapid/press-release_IP-19-2055_en.htm).

in 2015 has improved regulation significantly. China has also signed four of the eight key ILO Conventions. Finally, the EU has made ensuring higher environmental and labour standards one of its objectives for an investment agreement with China.

While all the concerns listed above are real and need to be tackled in negotiations with China, it is evident from the preceding discussion that many EU and US firms are doing very well in China or by trading with China. Given the very high trade tensions between the US and China, it is pertinent to consider the results of a 2019 American Chamber of Commerce in China survey (AmCham China, 2019). The survey found that firms are adjusting in various ways to the tariffs and the tensions, but very few are thinking of exiting the Chinese market. Asked what they most wished for from the ongoing trade negotiations, 43 percent of respondents wished only for a return to the status quo. Only about 10 percent mentioned fairer treatment, or improved intellectual property protection, and only 7 percent cited an end to market-distorting subsidies as a key concern. Very few respondents supported the imposition of tariffs, while 75 percent said tariffs hurt their businesses. US exporters to China and importers from China are – for obvious reasons – also opposed to tariffs. Relatively few sectors of the US economy (such as solar panels, and steel, which are protected by various trade remedy measures) compete directly with China nowadays.

## **9 Conclusion**

The large untapped opportunities for increased trade, investment and movement of people between China and the EU are evident, and these opportunities are likely to grow with China's rising weight. As the EU is in a relatively mature phase of its development, the growth opportunities of a closer relationship with China, and the boost that China can indirectly provide to Europe's traditional markets elsewhere, cannot be ignored. At the same time, the EU must insist that economic relations with China be based on as level a playing field as possible, or, in the technical jargon, should aim for something close to 'competitive neutrality'.

Based on that premise, the EU should raise its level of ambition with respect to closer ties with China. That will require stepping up its efforts to understand China, to coordinate its approach to China internally, and to establish a prioritised list of actions and approaches. Concluding the negotiation by the agreed deadline of a bilateral investment treaty which includes market access provisions would be an important step. The EU has recently concluded trade agreements with major partners, including Canada, Japan, and, in principle, Mercosur. The EU has also been engaged in on-and-off negotiations of an FTA with the United States for at least the last six years, during which 15 rounds of negotiation of the Transatlantic Trade and Investment Partnership were concluded.

The United States meanwhile is deeply engaged in negotiations with China that cover trade and investment relations and reform of the Chinese economy. It is time for consideration to be given to what a China-EU economic/trade agreement might look like, not entailing negotiations but rather the launch of analytical work and exchanges between experts from both parties. Such a step is especially important as a form of insurance in a context in which the viability of the WTO as the overarching organising framework for international trade is under serious threat (Dadush and Wolff, 2019). By taking a coordinated approach to China, the EU will bring a far greater weight to bear in negotiations than can its member states individually, and – in doing so – can avoid conflicts that might arise when members pursue divergent paths.



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