

# EUROPE IN THE MIDST OF CHINA-US STRATEGIC ECONOMIC COMPETITION: WHAT ARE THE EUROPEAN UNION'S OPTIONS?

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With the trade conflict between the United States and China bringing China-US strategic competition into the open, the European Union faces an urgent question: how to position itself in the competition. This paper reviews the impact of the US-led trade war against China and its immediate consequences for China, the US and the EU. Although protectionism can never be growth enhancing, European companies could see gains if the trade confrontation between China and the US ends up reducing their bilateral trade to the benefit of European companies that export to China. This is because US exports to China are concentrated in sectors that are also key for the EU's exports to China, with the exception of energy and agricultural products. However, a solution to the US-China trade conflict that artificially increases Chinese imports from the US can only hurt European exporters. A much broader and structural deal which pushes China to reform and open up would not only be beneficial for the US but also for the EU and the rest of the world.

Against this background, this paper reviews the EU's options in the new world of strategic confrontation between China and the US. The most obvious option would be to continue to safeguard multilateralism, but the EU should not be naïve in remaining alone, among major economic blocs, pushing for such an option. The second option would be for the EU to become more reliant on the Transatlantic Alliance. The last option would be for the EU to move its centre of gravity towards China, or at least to remain neutral between the US and China. While it might seem unrealistic today, this last option might need to be explored if the US continues to move away from multilateralism and, to some degree, from the Transatlantic Alliance. For the time being, the European Commission seems to have stepped up its thinking about the necessary conditions for stronger economic cooperation with China, which is already an important step in this direction.



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## 1 Introduction

The Trump administration's protectionist attitude to trade between the United States and China affects the European Union in several ways. First and foremost, it puts at risk multilateralism in trade relations and, in particular, the well-functioning of the World Trade Organisation (Jean *et al*, 2018). In addition, it opens the door to additional trade protectionism that could possibly target the EU, which has the world's largest trade surplus. Third, trade measures taken by the US against China and Chinese retaliation have indirect consequences for Europe. These can be positive for some sectors, and European exporters have gained a comparative advantage against US exporters in Chinese markets for those US goods on which import tariffs have been imposed and that Europe can produce (Wolff, 2018). Conversely, European exporters have an advantage in the US market compared to Chinese exports for those sectors targeted with tariffs by the US. However, this positive scenario becomes blurred when one thinks of the complexities of global value chains, which can lead to increases in European costs of production because of third countries' import tariffs as long as they lie within Europe's production chain (Chiacchio, 2018). This is, no doubt, the case with China.

Given the above complexities, it is relevant to analyse in detail what has happened so far with the US-China trade war, though it should be noted that trade is just one of the facets of much more structural economic confrontation between China and the US. We also analyse the EU's potential gains, at least at sectoral level, from the trade measures taken by the US and China against each other. Finally, we review Europe's strategic options in a world that is increasingly divided into two blocs (China and the US).

The next section summarises the background to the US-China trade war. Section 3 provides a review of US-China trade protectionism and the impact of the trade war on China and the US. Section 4 provides a sectoral analysis of trade measures taken by China and the US. Section 5 outlines the EU's first-best strategy in relation to the US-China trade war. The concluding section discusses how the EU should behave in the context of the US-China trade war.

## 2 An account of US-China trade protectionism

From seemingly untargeted measures announced in early February 2018 for solar panels and washing machines (Table 1), the US has moved to increasingly targeted action against China. The most obvious instance of this was the announcement of 25 percent additional import duties to be applied to \$50 billion equivalents of imported goods from China on the basis of China's infringement of intellectual property rights (Garcia Herrero, 2018a). More importantly, about two thirds of those import tariffs have been applied since 6 July 2018. The speedy introduction of the announced import tariffs by the US, without allowing much time for negotiation of a deal between China and the US, shows that the US is resolved to move away from the status quo in terms of the functioning of the global trading system, at least as far as China is concerned. On that basis, China had no choice but to retaliate with equivalent import tariffs on US goods.

Since then, the list of Chinese imports on which the US is aiming to increase tariffs has expanded to cover an additional \$200 billion of goods. Thanks to a truce reached on the sidelines of the Buenos Aires G20 summit in late 2018, the 25 percent US import tariff on an additional \$200 billion of goods from China was postponed, but it looked increasingly clear that this was just a truce to buy time for both sides, even though signals from Beijing talks in February 2019 suggested possible progress towards a "*partial deal*". The 1 December 2018 arrest of Huawei's chief financial officer because of a potential breach of sanctions against Iran<sup>1</sup> testifies to how far the US is ready to go in weaponising its current hegemonic position as a rule setter.

China's ability to retaliate against US trade measures is obviously more limited because it does not import enough good from the US to match the announced \$200 in US import tariffs. This explains why

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<sup>1</sup> See for example: <https://www.businessinsider.com/huawei-cfo-arrest-who-is-meng-wanzhou-2018-12?r=US&IR=T>.

China's second batch of retaliatory measures was more moderate, at least in size (\$60 billion). The Chinese retaliatory measures were put on hold thanks to the truce agreed in late 2018.

**Table 1: US trade measures**

Type of product	Solar panels/ washing machines	Steel / aluminium	Intellectual property (1102 products valued at \$50bn)	Intellectual property (6031 products valued at \$200bn)
<b>Rules</b>	Section 201 Import relief for domestic industries	Section 232 National security	Section 301 Intellectual property laws	Section 301 Intellectual property laws
<b>Effective Date</b>	7 Feb 2018	23 Mar 2018	25 percent additional duty effective on 6 July 2018 for 818 products (worth \$34bn) included in the proposed list on 6 April 2018, and 284 products (worth \$16bn) will undergo further review.	10 percent or 25 percent (under public review until 30 August 2018)
<b>Exemption</b>	'GSP-eligible' developing nations*	Australia, Argentina, Brazil and South Korea**	Targeted at China	Targeted at China
<b>Applied to China</b>	√	√	√	√
<b>Retaliation from China</b>	N/A	Tariffs on \$3 billion of 128 products including pork, fruit, nuts and wine of up to 25 percent	25 percent duty effective on 6 July 2018 for 545 products valued at about \$34 billion and 114 products valued at about \$16 billion with no effective date announced	5207 products valued at \$60bn (duties of 5, 10, 20 or 25 percent)

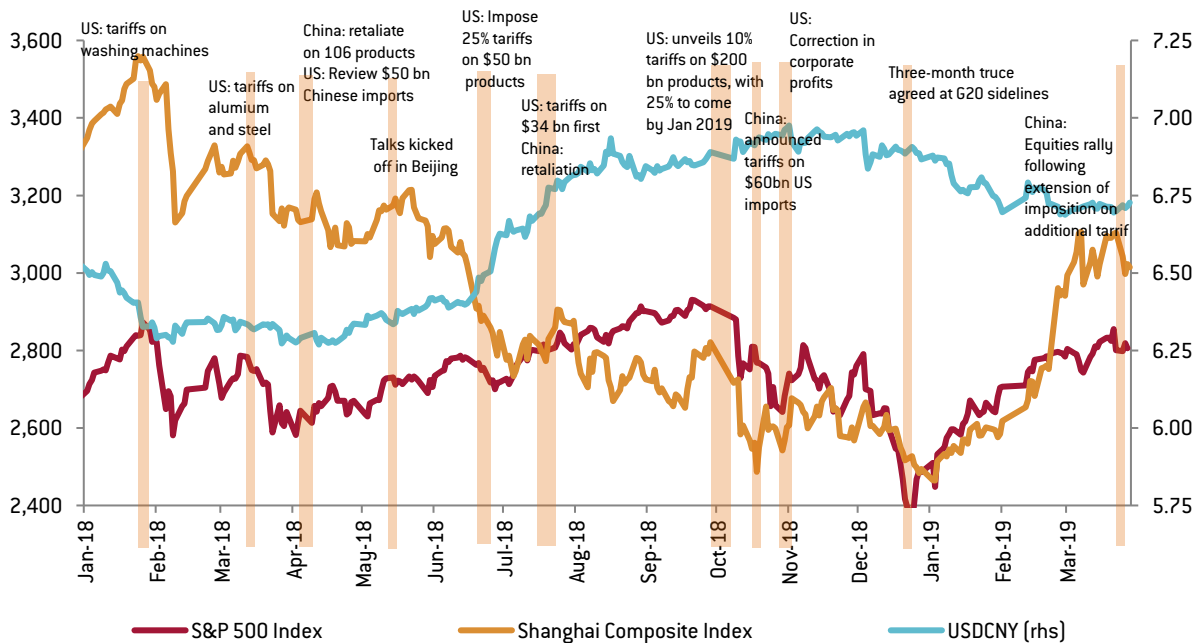
Source: Bruegel based on Natixis, US Government.

Notes: \* Philippines and Thailand are not excluded, even though they are GSP-eligible.

\*\* Exclusions from US steel and aluminium tariffs may take 90 days.

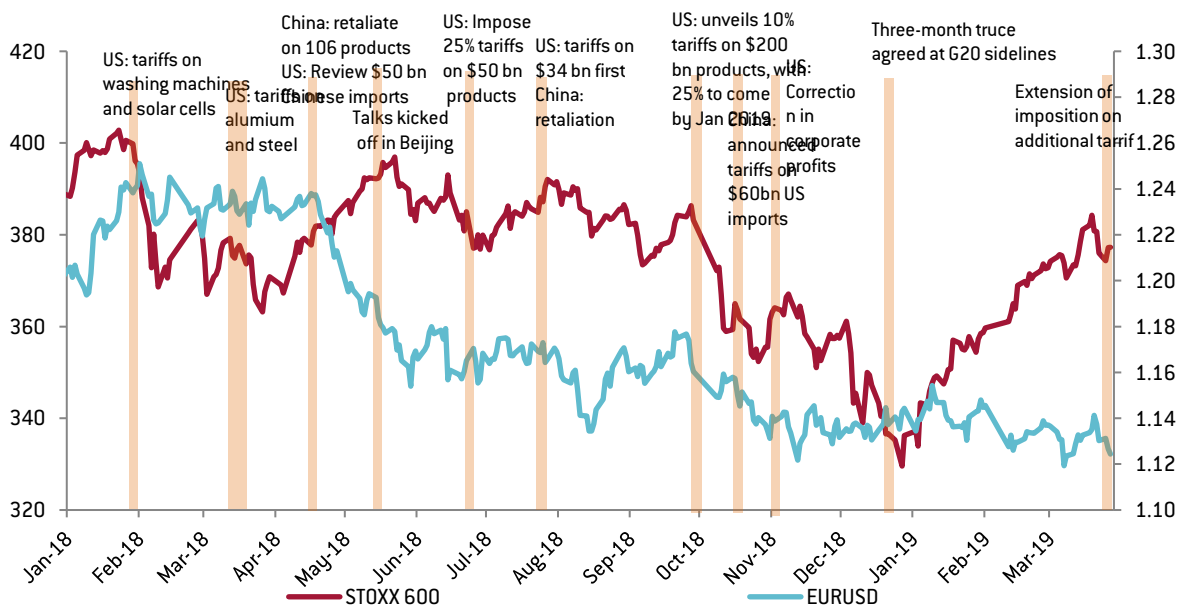
The market reaction to these developments seems to have been more negative for China than the US, at least as far as the stock market is concerned (Figures 1 and 2), which lost around 25 percent in 2018. While the market stomach cheerful news over a truce and potential negotiation progress, Chinese stock market has also been greatly influenced and gained 20% year to date. Furthermore, the renminbi has depreciated quite substantially since the beginning of the trade war, helped by the late 2018 truce between the US and China. One may wonder whether the market is overreacting to the potential consequences of such a trade war on China or, is perhaps underestimating the impact on the US. So far, European markets seem to have remained relatively more insulated from the US-China trade war, except when the US has pointed towards protectionism measures against Europe directly, as was the case when the tariffs on EU steel and aluminum were raised in spring 2018 and threats over increasing import tariffs on autos and auto parts were made in early summer 2018.

**Figure 1: Market reaction in the US and China**



Source: Bruegel based on Bloomberg, Natixis.

**Figure 2: Market reaction in Europe**

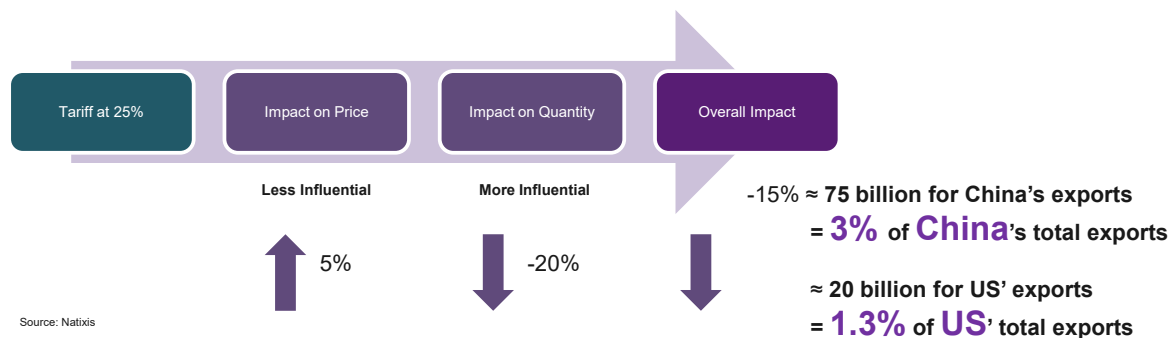


Source: Bruegel based on Bloomberg, Natixis.

On the potential economic impact of the trade war, there have been attempts to estimate the direct impact of tariffs on trade and, thereby, on growth. For example, the International Monetary Fund in its January 2019 *World Economic Outlook* estimated that the Chinese economy would grow 1.6 percentage

points less in 2019 and the US economy would grow 0.9 percentage points less in 2019 were the trade war to be maintained in 2019. Also, the euro area's growth rate would be revised down by 0.7 percent in that scenario. The World Bank, however, set out a much more benign scenario in its January 2019 *Global Economic Prospects* report, estimating that the both Chinese and the US economy would grow only 0.3 and 0.4 percentage points less respectively in 2019. Estimates of price and income elasticities of Chinese exports to the US (Garcia Herrero, 2018b) also point to a relatively limited value of China's total exports affected by tariffs. Even if the \$200 billion of Chinese exports was to be affected by the full 25 percent tariff, the overall impact on Chinese trade would be limited to only 3 percent of China's exports and only 1.3 percent of US exports (Figure 3).

**Figure 3: Estimate of the impact of a fully-fledged tariff war on China-US bilateral trade**



Source: Natixis.

Overall, the reason for this relatively limited economic impact, especially when compared with the very negative market reaction, especially for China, is that such exercises only take into account the direct effects on tariffs on trade and not the indirect effects on investment through a worsening of market sentiment, among many other channels. The impact on expectations and thus on future investment probably lags behind market fears, especially in China but also in the US and, to a lesser extent, Europe.

The issue is that market might be realising that the risk is not only protectionism but much more than that, because the ultimate goal of the US is to contain China. In fact, investors inside and outside China are starting to worry that their investment could be completely blocked by the US or indirectly affected by the worsening relationship between China and the US (Garcia Herrero and Xu, 2018). Moreover, the multilateral trade order maintained by the US is likely to be massively transformed. If that happens, the world will have to return to a much less free system for the flow of goods and services. Thus, market investors' sentiments went on a downward spiral in 2018 because of this increasing uncertainty.

One way to assess the potential impact of the ongoing trade war might be to look in more detail at the measures taken so far and analyse the rationale behind them, in order to draw conclusions about their potential consequences further down the road.

### 3 A deeper analysis of the US and Chinese trade measures

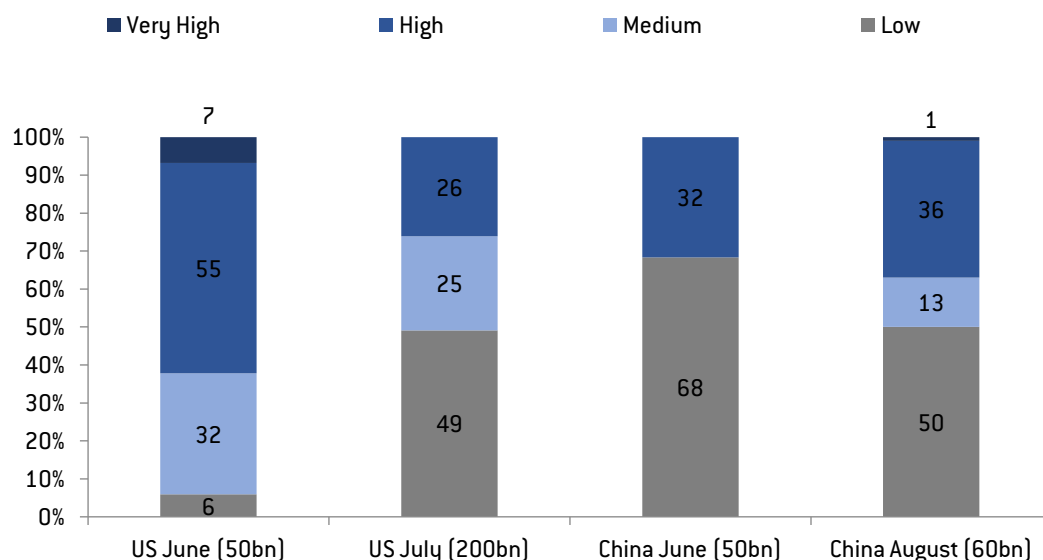
An analysis of the sectoral composition of the goods targeted by the US administration would give an indication of the US's structural goal in the trade war. The first round of US tariffs (\$50 billion) were aimed at China's high-end exports with a view to contain China's technological advance, with 7 percent of the tariffs on very high-technology products and 55 percent on high-technology products (Garcia Herrero, 2018c). Some of the products included in the US tariff list had not yet been exported by China to the US, including aircraft, aerospace, arms and ammunition. This indicates that the US's true intention behind the tariffs is not reduction of its trade deficit with China, but containment of China's upgrade on the technology ladder.

Very interestingly, China appears to have realised quite quickly what the US intention was. It rapidly modified its own retaliation list from a more balanced one which included high-end imports from the US (including aircraft and aerospace) to one more focused on low-end products, such as agriculture (especially soy) and energy. Such a strategy makes sense because imposing tariffs on high-end products that China does not yet produce or that cannot be sourced elsewhere would only hurt China. This is because it would increase the price of products needed for China to achieve its ultimate objective, namely, to move up the value chain ladder.

In the second set of US import duties of \$200 billion, initially to be imposed by August 30, the product composition seems very different. Low-end products dominate but, interestingly, very few are final – especially consumer – products (only 22 percent of total) but are rather intermediate products. One could interpret this second wave of import tariffs as a way to re-shore the production of intermediate goods back to the US (or at least to a third country that is not China) and to reduce China’s role in global value chains. This interpretation of the second round of tariffs could have tangible implications for third countries that are now part of value chains and have better economic relationships with the US (or even a free trade agreement, which insulates them from increases in US import tariffs across the board). This is the case for Vietnam and for Mexico (if the North American Free Trade Agreement is finally renewed). But the US has silently removed some key products that would be expensive to substitute in terms of increased prices for the final consumer (such as white goods, of which China has become the largest supplier by far).

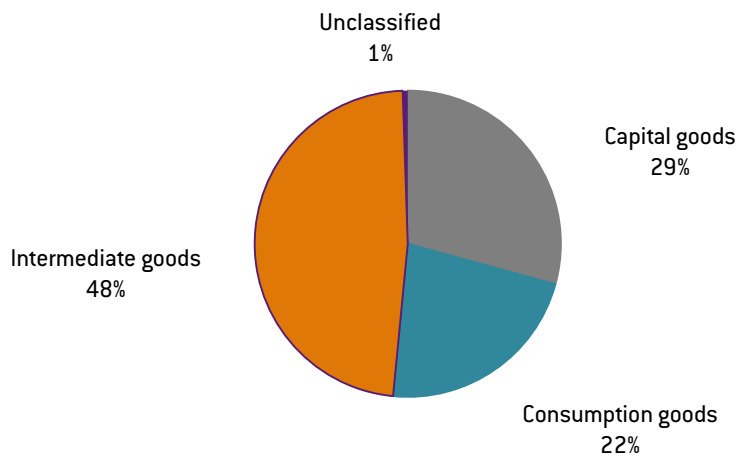
For this second round of tariffs, China’s retaliation is much smaller, covering only \$60 billion because of the limitation of the total volume of China’s imports from the US. Yet, it already takes up a large proportion of the total retaliatory list of imports from the US that China could further extend. In this round of retaliation, all low, medium and high technology products are included, which shows the determined stance of the Chinese authorities not to retreat before the US threat, taking into account China’s limited imports of high-technology products from the US. (Figures 4 and 5).

**Figure 4: A comparison of the US-China targeted products listed in June and July 2018 (%)**



Source: Bruegel based on Natixis, USITC, UN Comtrade.

**Figure 5: Decomposition of US imports from China under the \$200 billion tariff list**



Source: Bruegel based on Natixis, USTIC.

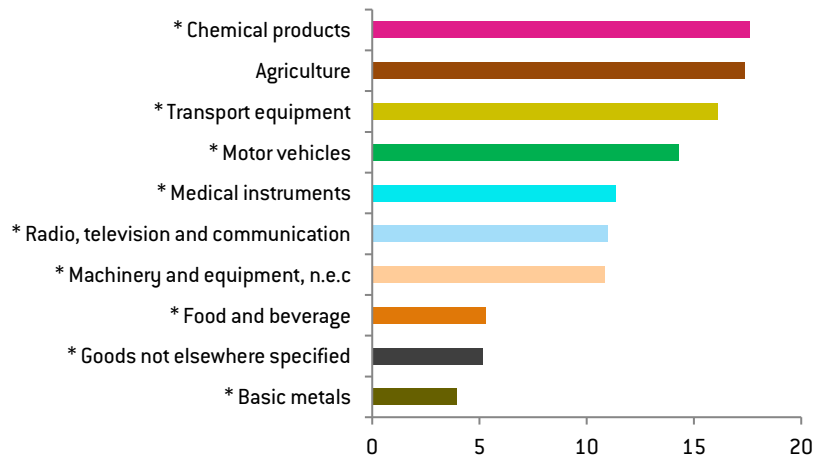
#### **4 What is the impact on Europe?**

How might the structural nature of the trade war between the US and China affect Europe?

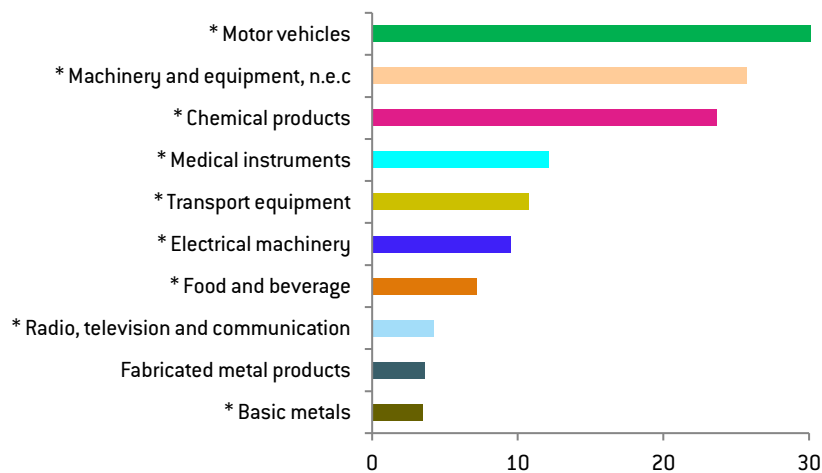
While a trade war can hardly have any winner in absolute terms, as trade is generally beneficial for global growth, there could be some relatively worse or better outcomes depending on the country and sector. If the current dispute between China and the US moves on with punitive tariffs applied to each other, the market space created in the two giants' territory should be, to a certain extent, filled by competitors from the rest of the world. As the biggest economic bloc in the world, the EU is, without doubt, a potential winner in this aspect. So far, the EU is the second largest exporter to both China and the US. This makes EU exporters most likely to take up the market shares of the Chinese and US companies caught up in the trade war.

At first sight, the size of the US market (€375.5 bn) is bigger than the Chinese market (€198.2 bn), which seems to give the EU more opportunities in the US than in China. However, a more granular product-level analysis is needed to understand the sectors that could potentially benefit from the trade war. When comparing the export structure of the three economic areas, we find that EU and US companies export more similar products than Chinese companies, which is unsurprising given the three regions different levels of development. For example, the top 10 Chinese imports (at the ISIC 2-digit level) from the US and the EU are exactly the same, including transport equipment, motor vehicles, medical instruments, machinery & equipment and chemicals (Figures 6 and 7). By comparison, the top two product categories exported from China to the US are office, accounting & computing machinery and white goods, which are not even among the top 10 EU exports to the US (Figures 8 and 9). This means, if the US and China do crowd out each other's exports; the EU's exporting structure would suggest more opportunities in China's market. Also, European products are potential substitutes for American products in the Chinese market but also the other way around, namely substituting Chinese exports to the US. It goes without saying that for Europe to reap such benefits, it would need to remain neutral in its trade policies and refrain from aligning with the US to impose tariffs on Chinese goods.

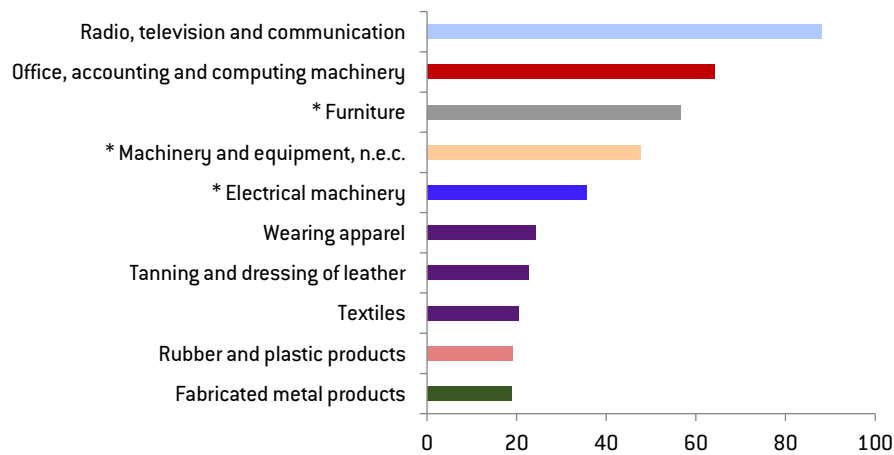
**Figure 6: China's top 10 imports from the US in 2016 (\$bns)**



**Figure 7: China's top 10 imports from the European-5 in 2016 (\$bns)**

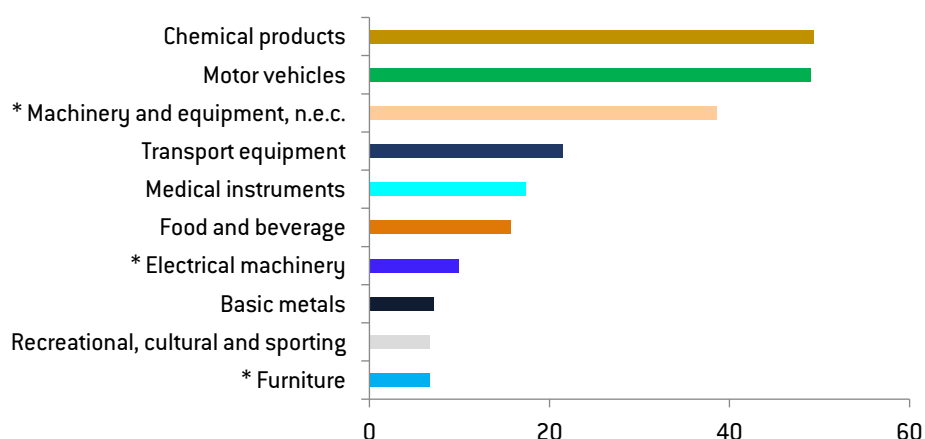


**Figure 8: The US's top 10 imports from China in 2016 (\$bns)**





**Figure 9: US top 10 imports from the European-5 in 2016 (\$bns)**



Source: Natixis, UN Comtrade Note: the same colour indicates the overlap of the US and the EU's exports to China among the top 10 imports in China.

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In such a case, one could estimate the potential maximum gains from substituting Chinese exports into the US and the other way around in the sectors on which tariffs have been imposed. The end result is that some specific sectors could benefit substantially, to the extent of nearly doubling their production for exports. This is especially the case for the general purpose machinery sector for the first \$50 billion package of import tariffs imposed by the US. EU exporters would clearly gain more from substituting Chinese exports into the US than the other way around. In other words, the EU dependence on the US goes well beyond the Atlantic Alliance and extends to economic issues such as trade dependence.

To quantify the benefits for European companies, we first calculated the product overlap (at the HS-6 level) between EU and Chinese exports to the US market, and the EU and US exports to China's market, respectively, and then confined the overlapping product list to the targeted products during the trade war. This gave us a list of the maximum gains that Europe can make for every product both in China's market and in the US market. Finally, we matched the HS-6 products to the 3-digit level ISIC Rev.3 sectors<sup>2</sup> to get the maximum potential gains for the EU. The relevant sectors were defined as those that have been targeted by the US or China (or both) with additional import tariffs and, at the same time, for which the EU already has exports of a certain product value (>\$1 billion) to the US or China (or both).

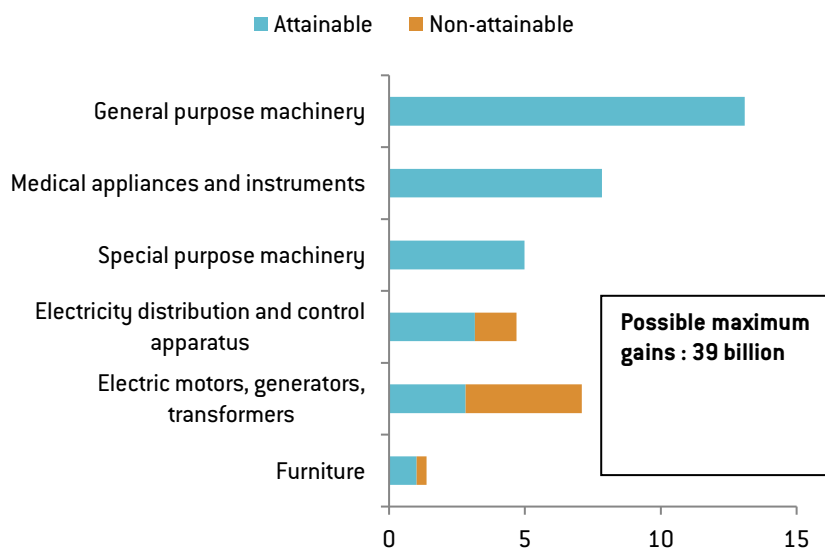
In the first round of the crossfire, both the US and China targeted \$50 billion of each other's products. The biggest winners (with potential gains of more than \$10 billion) from China's market are the EU's aircraft & aerospace and basic chemicals sectors, and the general purpose machinery sector from the US market (Figures 10 and 11). While both countries target the exact same amount of imports, the potential sector gains are higher in the US market (\$39 billion) than in China's market (\$30 billion).

In the second round of the crossfire, the US escalated the tariff list to \$200 billion of imported products from China (although the current truce has limited the tariff increase to 10 percent instead of the 25 percent planned). This again gives European firms more room to access the US market, with the possible maximum gains reaching \$97.6 billion (or 50 percent of the total). The benefits will now be extended to some of China's key exporting fields such as office, accounting & computing machinery as well as furniture, both of which are already among the EU's top 10 exports to the US and have the potential to substitute for China's exports (Figures 12 and 13). That said, the two sectors are restricted in their

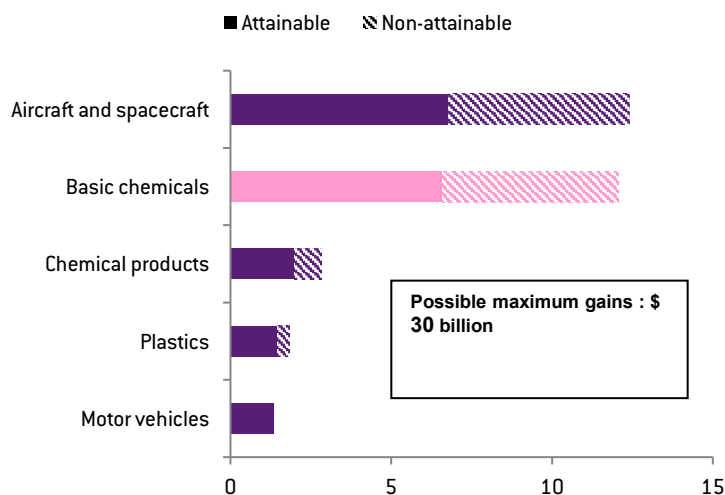
<sup>2</sup> We used the concordance table provided by the WITS to convert the HS classification into the ISIC Rev.3 classification.

current capacity to replace the related products in the second round of the US tariffs, as China's exports to the US of these products are more than seven times as large as the EU's current exports, so it would take a long time for the EU to accumulate enough capacity to replace Chinese producers<sup>3</sup>. On the other side, the EU's relative benefits in China's market are much smaller as the tariff list only covers \$60 billion of products in total (only \$38.5 billion but a larger percentage of the total amount of goods on which tariffs have been imposed, namely 66 percent). In China's market, European gains will be extended to medical & precision products and basic chemicals, and to a lesser extent, to general purpose machinery.

**Figure 10: Europe's gain on the US market for the first \$50 billion of tariffs on China (for sectors > \$1 bn)**

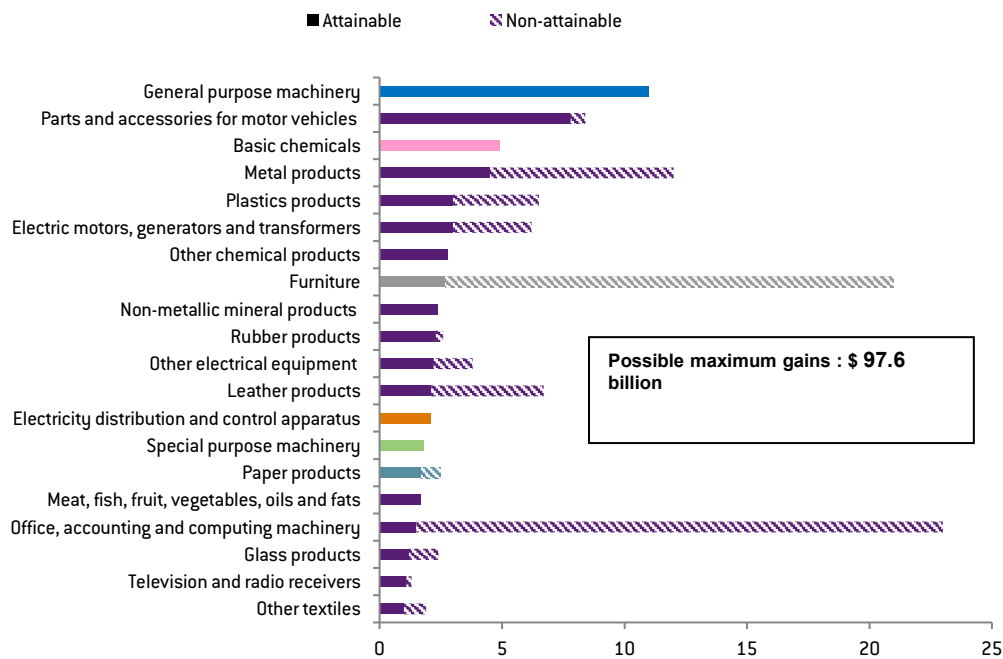


**Figure 11: Europe's gain on China's market for the first \$50 billion of tariffs on the US (for sectors > \$1 bn)**

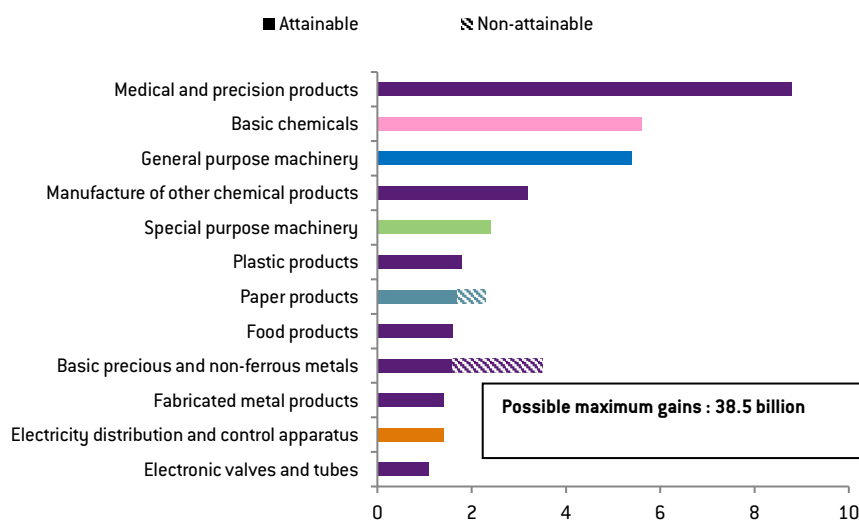


<sup>3</sup> In the calculation of the maximum gains, we took into consideration the capacity restrictions by calculating the maximum gains as three times as large as the current exports of EU companies.

**Figure 12: Europe's gain on the US market for the second \$200 billion of tariffs on China (for sectors > \$1 bn)**



**Figure 13: Europe's gain on China's market for the second \$60 billion of tariffs on the US (for sectors > \$1 bn)**

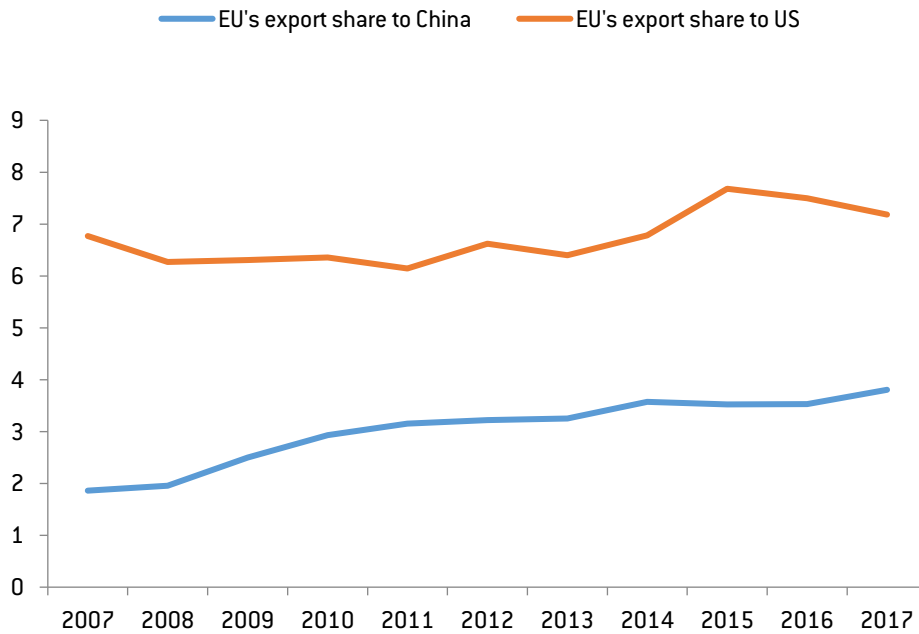


Source: Bruegel based on UN Comtrade and the concordance table from WITS. Note: The calculation of the sector's maximum market gain is based on all the related goods in the first round of the tariff lists. The solid part of the bar indicates the EU's current exports to the destination market.

That said, potential European gains will very much depend on Europe remaining neutral in the US-China trade war, instead of following the US by imposing import tariffs on China. If the EU is forced to pick the US side and impose its own import tariffs on China, China will probably also retaliate against EU companies. It should also be noted, though, that the potential gains are greater in the US (beyond the already larger export revenues) largely because of more tariffs imposed by the US side. In other words, beyond Europe's historical alliance with the US which will keep EU policies closer to the US than they would ever be with China, the EU also fears losing the US market even more than that of China because

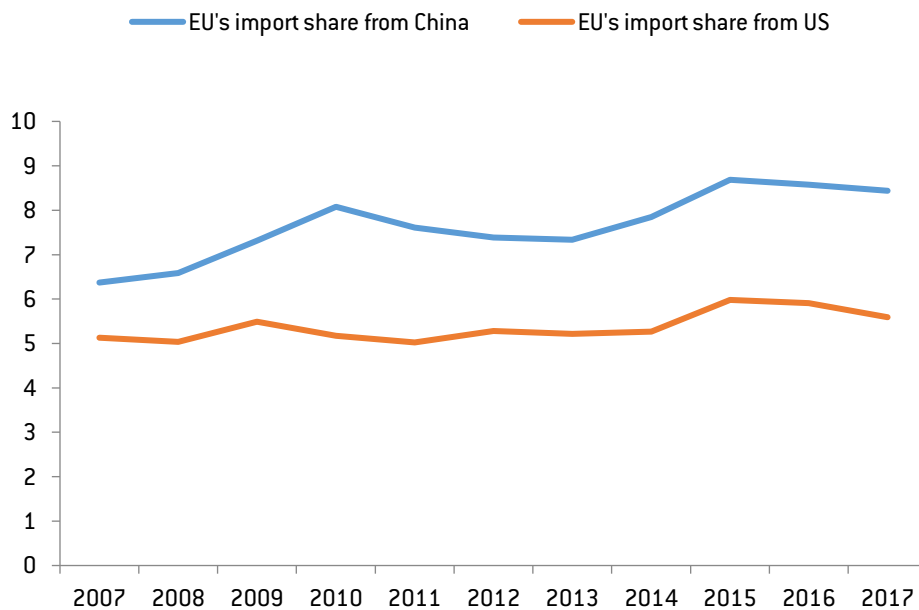
its share of exports to the US is larger than China's (Figure 14) while China remains more relevant for EU imports (Figure 15). The fact that Europe, an overall net exporter, continues to maintain a bilateral trade deficit with China does not help (Figure 16). Obviously, a neutral stance towards China is the best of all situations with some clear winners among European export sectors, but the US clearly comes first in the EU's ranking of interests, even if only trade gains are considered.

**Figure 14: Share of EU's exports going to China and the US, 2007-17, %**



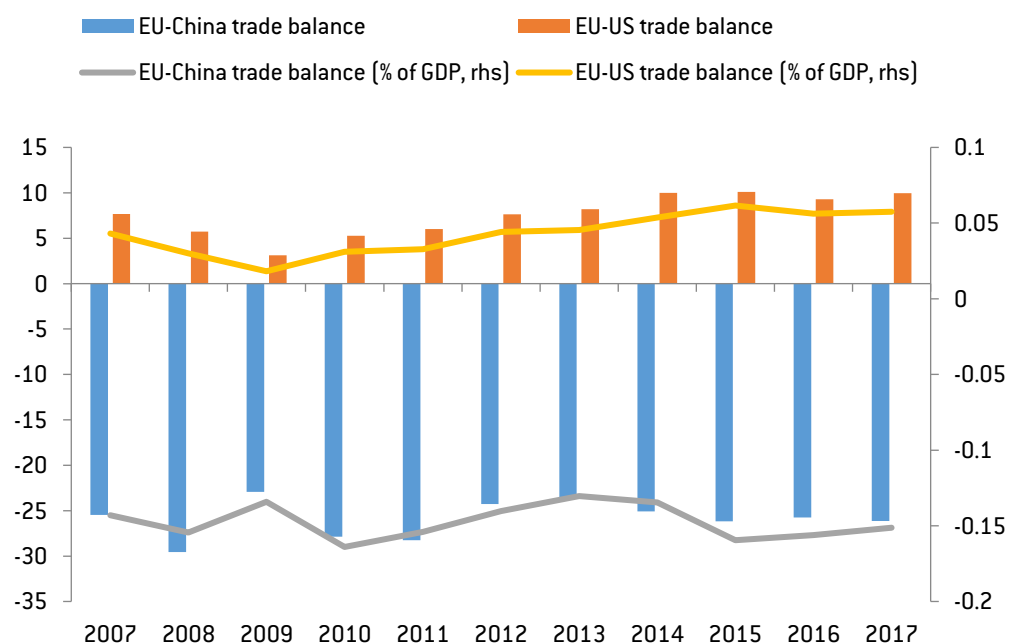
Source: UNCTAD

**Figure 15: Share of EU's imports from China and US, 2007-17, %**



Source: UNCTAD

**Figure 16: Europe's trade balance with China and the US, 2007-17, US\$ billions**



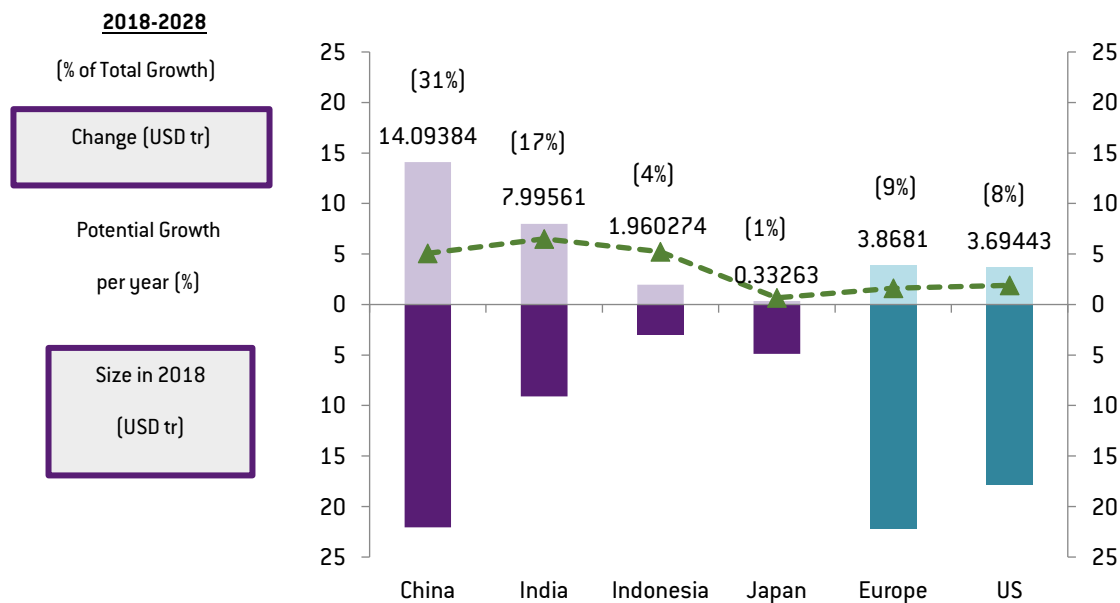
Source: UNCTAD

All in all, our analysis shows US-China trade frictions are here to stay insofar as they are part of a fight for hegemony in the global economy. The US wants to contain China's future – which basically implies direct competition with Chinese products in third markets. In that respect, Europe, being export oriented and with a similar economic structure, can benefit by substituting some of the US's exports to China. This, however, requires no retaliation from the US towards Europe. Otherwise, it will be extremely difficult for the EU to keep a neutral stance in the trade war.

### **5 Options for Europe in the light of increasing economic competition between China and the US**

The US-China trade war has brought about not only short-term trade tensions, but also, and more importantly, a systemic shift in the trade order that has supported the world's development for the past century. Undoubtedly, the US and China will be the most influential blocs in the twenty-first century, and their conflict is doomed to be long-lasting. While the two countries might find a temporary solution to the current tariff disputes, their conflicts are intrinsically embedded in the competitive stance that could only be exacerbated in the future. This is all the more natural when one realises that China's economy is already as large as that of the US (at least in purchasing power terms and soon in dollar terms) but, most importantly, will contribute more than three times the US to the global economy in the next 10 years (Figure 17). In other words, although the US is a more important market for Europe today, this will soon no longer be the case, based on the positive growth differential between the US and China, which continues to be very large.

**Figure 17: Contribution to world growth (USD trillions, %)**



Source: Bruegel based on Natixis, BBVA EAGLE, IMF, Oxford Economics.

The global influence of the US-China cold war will be persistent. At this juncture, as the world's only economy that can balance the power between the US and China, the EU has to decide how to respond to the trade war. Several options are under discussion.

**Safeguard multilateralism?**

The EU has long called for economic multilateralism and is pushing for reform of the World Trade Organisation to adapt to China's sheer size. One could argue that one of the key areas of contention for the US is China's different economic model, though China is part of a free trade world. The European response to this reality is to keep to, if not enhance, multilateralism, by reforming existing institutions, especially the WTO, to impose market practises on all members in order to protect fair trade (Demertzis, 2018)<sup>4</sup>. This means that the WTO will need to address the issue of the large role of state-owned enterprises (SOEs) in the production of goods and services and the pervasive role of production subsidies. This would bring the WTO close to US concerns about China's unfair practices in international trade.

While the EU may easily find common ground on the key issues with the US (only if the current US administration were to engage in such reform, which is not the case at time of writing), persuading China of the need for reform could be hard. In fact, the role of SOEs is considered key to China's model of socialism with Chinese characteristics and, thus, impossible to dismantle in the foreseeable future. China will argue that the role of SOEs remains moderate<sup>5</sup> and, thus, should not be an issue for WTO reform. The Chinese have also borrowed the concept of competitive neutrality from the Organisation for Economic Cooperation and Development (OECD) and argue that they are increasingly close to applying competitive neutrality among companies operating in China. Garcia and Xu (2017) took a very different view of the role of SOEs in the Chinese economy both because of their more pervasive influence and,

<sup>4</sup> For more detail on how Europe can defend multilateralism and what the options are for Europe, see Jean *et al* (2018) and Wolff (2018).

<sup>5</sup> According to China's National Bureau of Statistics, in 2015 SOEs accounted for 38.8 percent of total assets for industrial enterprises above scale.

more importantly, because of their very different nature to other SOEs around the world. In fact, the key reasons for their unequal footing with other companies operating in China, including private Chinese companies, are their preferential access to the market in many sectors and their special connection with China's Communist Party.

That said, the EU will also find cooperation with the US difficult in the reform of the WTO. Since his election, President Trump has pushed 'America first' policies and has certainly not supported multilateralism. Tariff measures taken by the US based on 'security' justifications while bypassing the WTO's multilateral settlement mechanisms clearly show that the US might overthrow the multilateral order to pursue its own interests. As such, while the US seems to share with the EU to a great extent market and democratic values, it does not seem ready to fully conform to the EU's proposal for WTO reform that will preserve multilateralism. On the other hand, China's expectations of WTO reform do not seem to be in line with the EU's. In fact, China expects to enjoy a special status as an emerging economy, which should allow China to continue to keep its economic model while continuing to enjoy the benefits of open trade.

While ideal in terms of the benefits of the status quo for an open, export-led economic bloc like the EU, the reality is that the EU risks remaining isolated in its pursuit of multilateralism, at least in the form we understand it today. Being the last one to abandon the boat of WTO reform is probably courageous but also naïve and potentially costly for the EU. All in all, while continuing to make efforts to preserve multilateralism, Europe might need to explore other responses to the new reality of a structural competition between China and the US.

### **Enhancing Europe's reliance on the Transatlantic Alliance?**

Another potential option for Europe is to reinforce its alliance with the US to the point of following the US in its actions to contain China's economic/technological rise. In other words, the EU could also choose to lean completely towards the US. The question is how wise this would be in the current environment in which there have been clear changes in the US attitude towards multilateralism. This is all the more disappointing as it was the US that pushed for such a system, as a way to create a safe environment for its allies and eventually to engage with the rest of the world after the collapse of the Soviet Union.

The current US administration has made it very clear that multilateralism and open trade is something of the past. The US has taken aim not only at China but at many other economies including the EU. In 2018, the US threatened tariffs on EU steel, aluminium and cars. It also criticised the EU for its large trade surplus with the US. As such, the EU alliance with the US could become more costly for the EU than it has ever been because the US is unhappy with the current distribution of costs and benefits of the Transatlantic Alliance.

More importantly, because the US has chosen a non-market bilateral means of dealing with China (among other issues), the EU's complete support for the US will mean that it has to give up on its rule-based approach to problem solving and, thereby, its principles and values. This would be obviously very costly for the EU because its own internal market is based on a strong rule-based system as a core value. The case for the reform of the WTO is an illustration since the EU is really keeping to the rules and a clear dependence on the US might force a change in the EU's current strategy.

There is another practical reason that would make it very costly for the EU to lean on the US completely. The EU is not a single country, but a group of countries that have different views about the US and also about China. While Western Europe might be easier to unite against China, Eastern Europe, together with the Western Balkans, have gone in the other direction with the 16+1 group, which implies close cooperation with China in a number of economic policies. As if this were not enough, also some Western/Southern EU member states are taking the same route, starting with Greece, followed by Portugal and Italy, a founding member of the EU. The EU's efforts to establish an EU-level system for

screening foreign direct investment, which was finally adopted on 5 March 2019<sup>6</sup>, but was clearly weakened compared to the original proposal, points to the difficulties of moving unitedly to a closer Transatlantic Alliance to the detriment of EU member states relations with China.

### **Strengthening cooperation with China**

Strengthening cooperation with China is also a practical – albeit unlikely – choice for the EU insofar as its current strategic ally, the US, is clearly watching Europe and making it increasingly costly for Europe to move away from its historical anchor, namely the US. However, even the cost of a more neutral position (equidistant between the US and China) are increasing, the Chinese market is simply too large to be avoided. This means that the opportunities in the medium term should be greater in China than in the US, under a very important assumption, though, namely that China truly opens up to foreign competition. In other words, if China were to grant true market access to foreign companies (European companies), the benefits for Europe of remaining neutral between the US and China may skyrocket.

This is why most of the discussion about whether Europe should rebalance its economic partnership towards China, at least to the point of neutrality between the two hegemonies, boils down to improving European companies' market access in China. Improving market access is much more than opening up certain sectors in China to foreign competition. It must also include equal treatment in that market, which is a much harder condition to be achieved given China's state-led economic model. This point is clearly set out in the recent position published by the European Commission on China (European Commission, 2019).

In that context, the EU has taken some steps to improve economic cooperation with China since 2013 but the current stand-off with the US constitutes one more important hindrance (beyond China's apparent lack of interest to change its state-led model) for such negotiations to bear fruit. In fact, the twentieth round of EU-China bilateral investment treaty (BIT) negotiations in February 2019 finished without an agreement and, at time of writing, there is no precise date for the twenty-first round<sup>7</sup>. The key stumbling block is indeed market access for European companies in China and reciprocity, which is of course related to the perceived lack of market access. In the same vein, EU authorities are concerned about potential discrimination against EU investors operating in China, including explicit or implicit preferential subsidies for certain enterprises. Such discrimination might also be a factor for Chinese companies operating in Europe. While market access is a more general issue, potential discrimination by means of implicit or explicit subsidies is linked to the role played by Chinese SOEs. This is not only true for the Chinese economy, but also for Chinese investment in Europe because a good part of it (most of it until very recently) originates from SOEs.

In China, SOEs have a much wider scope as they originate from the planned economy era when they dominated all sectors (either SOEs or collectively-owned companies). Most Chinese SOEs, even now, are not established on the basis of correcting market failures, but more to carry out government objectives. Chinese SOEs are bigger, more pervasive and more dominant than their EU counterparts. More importantly, they exist in nearly every key sector in Chinese society (Table 2). Against this backdrop, the Chinese government has created a special favorable environment for the SOEs, which has triggered concerns over unfair competition in the international market and is one of the key barriers in the way of China building an economic alliance with the EU.

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<sup>6</sup> See <https://www.consilium.europa.eu/en/press/press-releases/2019/03/05/council-greenlights-rules-on-screening-of-foreign-direct-investments/>.

<sup>7</sup> The twenty-first round is, at time of writing, provisionally scheduled for June 2019 in Beijing.



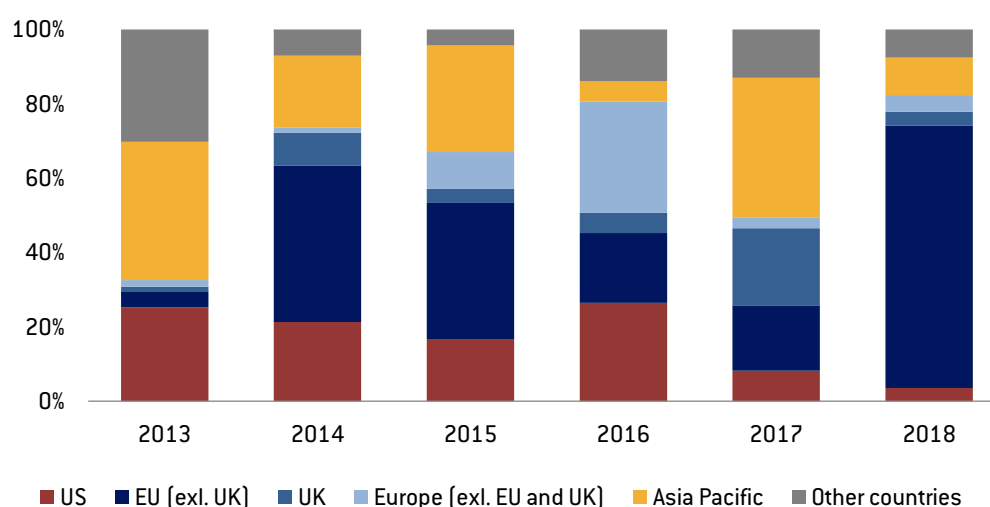
**Table 2: Sectoral sales distribution of State-owned Enterprises (SOEs), Private-owned Enterprises (POEs) and Foreign-Owned Enterprises (FOEs) in China in 2008, in percentage**

Sector	SOE	POE	FOE
Health	58.92	41.06	0.02
Wholesale & Retail	2.20	97.73	0.08
Construction	24.43	75.26	0.30
Culture	54.71	44.36	0.94
Education	34.06	64.85	1.09
Finance	21.74	76.78	1.48
Accommodation	25.96	71.60	2.44
Real Estate	7.32	90.11	2.57
Environment	43.65	53.51	2.83
Research	33.94	62.28	3.78
Lease business	26.94	64.65	8.41
Restaurant	4.00	86.96	9.04
Manufacturing	15.11	75.26	9.63

Source: Bruegel based on China's Economic Census Data.

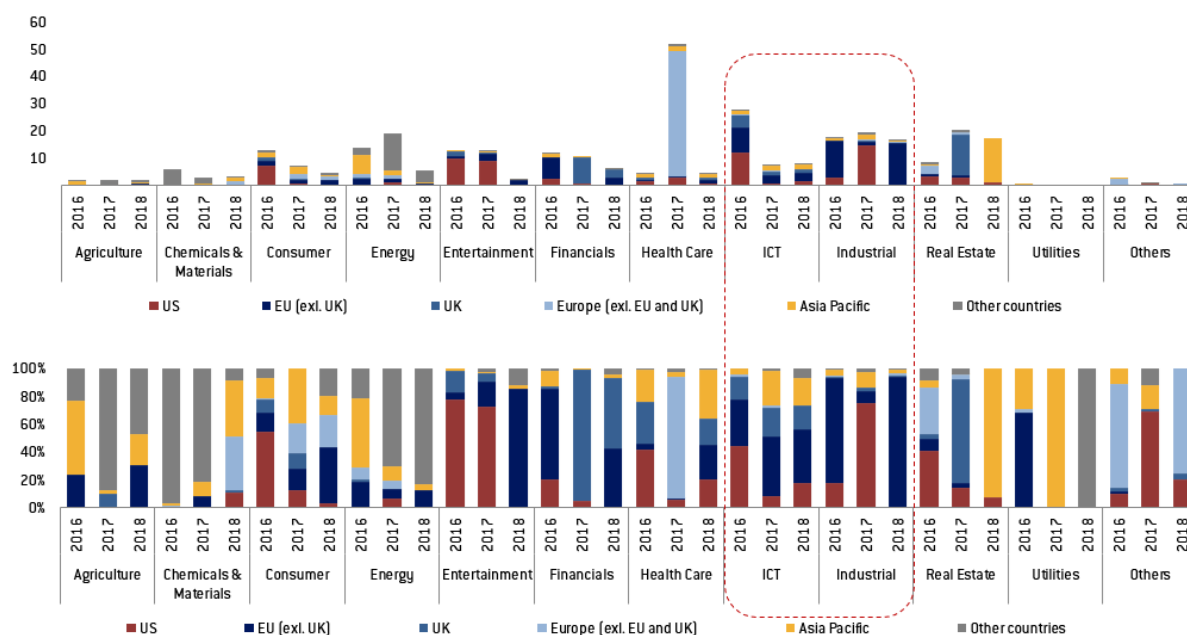
Beyond market access and reciprocity, a new important roadblock has appeared for the negotiations on a bilateral investment agreement, namely the massive Chinese investment into strategic companies in Europe. In fact, Chinese investment in the EU is ballooning while EU investment in China is slowing down and is already smaller than Chinese investment in the EU. More specifically, in 2011, China's outward FDI (including that from Hong Kong) accounted for only 1 percent of EU total inward FDI, whereas China took 3.5 percent of the EU's outward FDI. Given the size of the Chinese economy in the world already in 2011, this can be considered relatively modest. The situation today is very different. As shown in Figure 18, the EU27 (excluding the UK) has seen the largest growth in attracting Chinese investment in 2018, particularly in the industrial and ICT sectors, reaching 70 percent of China's total overseas M&A in value. (Figure 19). Because the US has closed its door to China on the basis of national security concerns, the EU is now the only place that is easier for China to access in terms of buying foreign companies.

**Figure 18: Destination of overseas completed M&A, % by deal value**



Source: Bruegel based on Mergermarket, AEI, NATIXIS.

**Figure 19: Regional and sectoral distribution of China's overseas M&A, deal value (top panel) and % of deal value (bottom panel)**



Source: Mergermarket, AEI, NATIXIS

All in all, given the increasingly difficult relationship with the US, the EU should explore a certain degree of rebalancing towards China. However, the key stumbling block will continue to be China's state capitalism and the lack of market access for foreign companies. In relation to SOEs, preferential market access in China, rather than ownership of SOEs, should be the key consideration for European policymakers when evaluating the undue advantage enjoyed by Chinese corporations. This is because private companies with ties to the Chinese government might also benefit from preferential market access. The close ties between Huawei's founder and concerns over its help in spying can be a good example showing how much the Chinese leadership may be found behind key private companies, especially if they belong to strategic sectors.

More generally, the first priority issue that an EU-China BIT should pursue is market liberalisation, so that any market access granted through the BIT puts European companies on an equal footing to their Chinese competitors (even SOEs). This obviously requires, at minimum, reciprocity (García Herrero and Xu, 2017). In fact, market liberalisation is important not only for foreign companies but also for Chinese private companies, so that gains are also shared with China (Grieger, 2016).

While engaging with China in terms of liberalisation and opening up, the EU cannot remain fully open to China's acquisitions of technology and the entry of Chinese state-supported companies into the single market. Europe has adopted a stricter framework for the screening of foreign investment in March 2019, namely the EU-level foreign direct investment screening system (mainly directed at Chinese companies). Still, three key instruments might be used if some reinterpretation of the EU Treaty is included in the picture, namely competition, dispute resolution and state aid policy. The first does not require explanation nor does state aid policy, with the caveat that it cannot yet be applied to non-EU countries. As for dispute resolution, identifying unfair behaviour by a firm can be easier after a firm reveals its status by operating in the EU market. An appropriate dispute settlement mechanism would protect both European and Chinese companies. Among the different options, an investor-state dispute settlement system (ISDS) seems to be favoured internationally, but would need to be revised so that governments (either China or EU governments) do not fall prey to corporates suing them without clear justification. Furthermore, in the Chinese case, the very close links between corporations and the

Chinese government (especially when operating abroad) could make ISDS a double-edged sword for the EU, because in certain cases China could, for its own purposes, support its enterprises in suing EU governments. In addition, the implementation of the ISDS might be difficult in China, where experience with investor-state arbitration is rather limited and there is a very low probability that the Chinese government will enforce foreign court decisions (US-China Economic and Security Review Commission, 2016). A revision of the ISDS is thus warranted to balance the interests of the parties in the BIT negotiation.

As such, we could see that Chinese internal reform is the key for the EU to pursue a stronger relationship with China. The priority issue that the EU and China need to pursue is market liberalisation, so that any market access granted through the BIT puts European companies on an equal footing to their Chinese competitors (even SOEs). This obviously requires, at minimum, reciprocity. But there is still a long way to go.

## **6 Conclusions**

This paper has reviewed the impact of the US-led trade war against China and its immediate consequences, not only for China and the US, but also with particular discussion for the European Union. The first point to note is that, although protectionism can never be growth enhancing, and certainly not for a net exporter like the EU, there are still gains to be had by European companies from the ongoing US-China trade confrontation, insofar as they can substitute US exporters selling into China or Chinese exporters to the US, though there is less opportunity here according to our findings. The truce agreed between the US and Chinese governments on the sidelines of the Buenos Aires G20 meeting and possible negotiation progress towards an increase in China's import from the US might reduce such opportunities for EU exporters and might even create trade diversion again away from European products and in favour of American products.

The fact that the EU feels increasingly squeezed by the strategic competition between the US and China should push the EU to ponder its options in the current global set-up. So far the EU has supported multilateralism at any cost. Unfortunately, this support for multilateralism is increasingly fruitless as the US seems to have no intention under Trump's administration of reverting to the model it once helped create. On that basis, and given Europe's reluctance to play a leading role without the US, the push for a return to multilateralism seems more an option of the past than an option of the future. The second most obvious option for the EU would be to increase its dependence on the US or, in other words, to push its strategic alliance further. However, this would come at a cost, in particular in two ways. The first is the increasing unreliability of the US as ally and a seemingly different distribution of costs and benefits for its allies (more costs for the EU, but fewer benefits on the trade side). The second caveat would be the need to align against China in issues of interest to the US. Although such issues are not too different from the complaints raised by the EU about China (market access, reciprocity, excessive role of the state in the economy and stronger defence of intellectual property rights), the reality is that the US interest will come first in this battle. The EU could lose its potential preferential access to China because of the choice to enter into a stronger alliance with the US. Finally, the third option, namely rebalancing toward China, at least partly, cannot be an option for Europe in the current circumstances because of very limited access to the Chinese market. However, if China were really to further open up its economy to foreign competition (i.e. offer full market access), this option could become much more interesting. Based on the past experience since China entered the WTO, this option seems highly unlikely but is worth pursuing. In that context, China's willingness to open up its markets to foreign competition clearly requires market access and reciprocity. While China makes up its mind on whether this is a real option, the EU has no choice but to protect its strategic sectors from Chinese acquisition and to safeguard the single market against unfair competition from Chinese SOEs.

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