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Don't Go Protectionist!

Trade and Investment Relations between the EU and China

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The European Parliament has proposed the creation of a body to monitor foreign – in particular Chinese – investment in the EU. The initiative, driven by fears of unfair competition and a hidden political agenda behind Chinese investments, should be rejected. There are better ways to promote openness and transparency in Sino-European economic relations.

Rising investment flows by Chinese companies within the European Union have fueled debate over whether these ventures might have ties to the Chinese government – and thus a partially strategic aim – raising the question of whether tighter control of Chinese investment activities might be necessary. The European stance on these issues is unequivocal: China is accused of creating unfair competition by providing preferential policies to its domestic firms. These are therefore able to undercut Western incumbents by engaging in so-called dumping, or pricing goods unrealistically low, in violation of WTO rules. Moreover, Western companies in China have to face serious infringements of their copyrights and are discriminated against in public procurement processes, while Chinese companies in the European Union can compete on equal footing with European incumbents. Thus in May 2012, the European Parliament (EP) adopted a resolution proposing the creation of a body tasked with monitoring foreign investment, with particular emphasis on investment from China.

This, then, is the European perspective. Much less has been written providing the Chinese point of view. In China, it is widely held that Western nations tend to apply different standards to the international trade and investment regime largely created by themselves. Moreover, Chinese policymakers see Western leaders as failing to sufficiently acknowledge the differences in the development stage of their trading partners and focusing too heavily on political issues, thereby sometimes neglecting important economic factors. With these conflicting accounts each gaining currency in their respective regions, it appears time to take a step back and try to see both sides of the EU-China trade and investment picture.

China has surged powerfully back to the world stage since instigating its policy of reform and opening (gaige kaifang) in the late 1970s, certainly from an economic perspective, but recently politically as well. Trade and investment relations between the EU and China have intensified to an unprecedented degree over the last three decades. To outside observers, China's vast geographical size, huge population and annual growth rates averaging near 9 percent give it the appearance of a giant. It is thus unsurprising that the country's rise has nurtured fear and insecurity within the EU. Indeed, it is a widespread perception among European politicians and media commentators that the "dragon's insatiable hunger" endangers Western dominance and

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the global supply of energy and resources. China's so-called state capitalism subjects companies from Western market economies to unfair competition, not only in China itself, but also on international markets. The Chinese model seems gradually to be evolving into an alternative development path that eschews Western values such as democracy and human rights – societal features long believed to be foundational elements in a superior road to growth and happiness. To some Western observers, a "war of systems" seems likely.

However, it must be noted that as of today, the evolution of trade and investment between the two regions shows a strong bias toward creating a win-win situation. Growth rates for Sino-EU trade and investment flows, especially since China's WTO access in 2001, have been impressive. This intensifying economic relationship has contributed substantially to the enhancement of welfare gains in both China and the EU. To maintain the win-win situation in Sino-European economic exchanges, both sides must adhere to a general and mutually accepted system of rules as provided by the WTO for trade relations. This paper thus offers some suggestions on how to increase transparency and openness in investment as well.

I. EU-China trade and investment – a brief overview

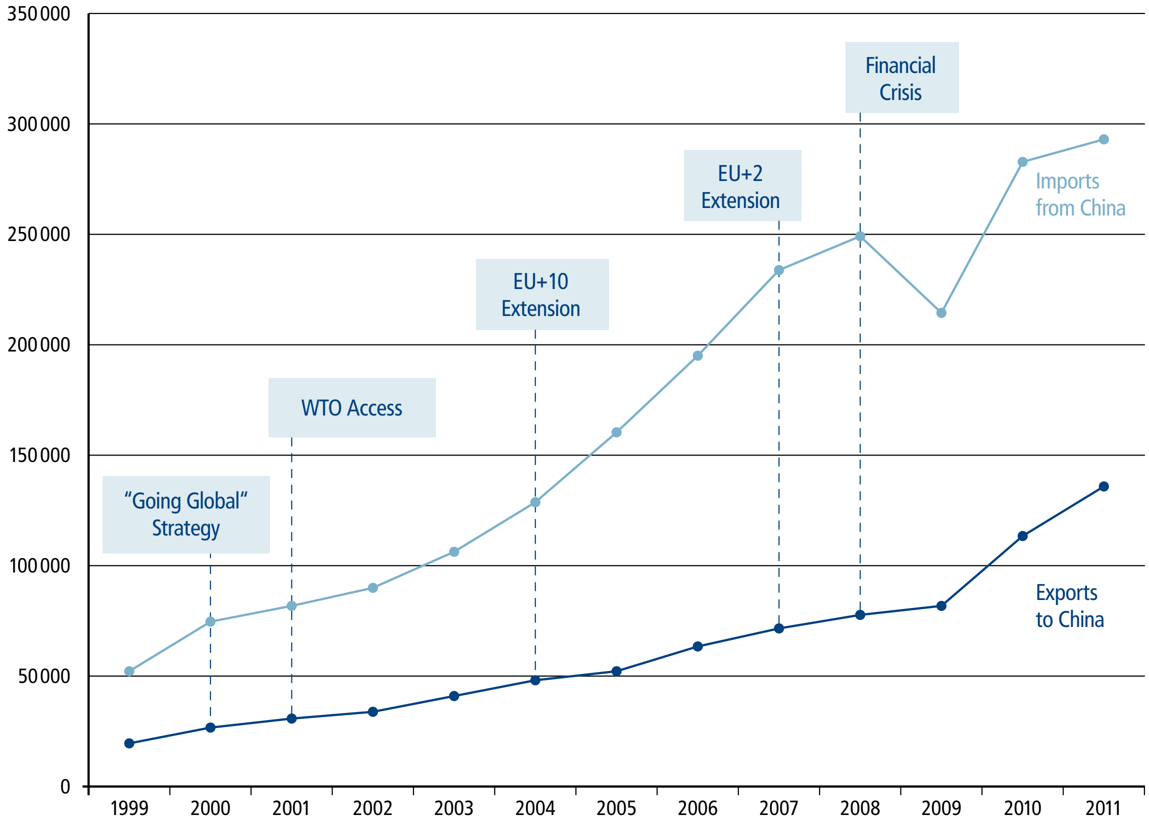
Following its Eastern extension, the European Union replaced the United States as China's biggest trading partner in 2004. For its part, China is currently the European Union's second-largest trading partner. Exports from China have been rising far more quickly than imports to China, a fact which has triggered huge deficits (€156 billion in 2011) and laid the foundation for continuous trade disputes.

Relations between the EU and China (1975-2012)

	Important milestones
1975	Establishment of official diplomatic relations
1985	EC-China Trade and Cooperation Agreement
1989	Imposition of sanctions on China in response to the violent intervention on Tian'anmen Square (arms embargo ongoing)
1992	Deng Xiaoping's "Journey to the South" pushes mutual economic relations
1995	Establishment of EU-China human rights dialogue EU publishes first Communication on China-Europe relations
1996	First Asia-Europe Meeting (ASEM)
1998	First EU-China Summit
2000	EU and China reach agreement on WTO access
2001	China enters the WTO after 15 years of negotiations
2003	China's first strategic paper on EU policy Launch of EU-China comprehensive strategic partnership
2004	EU replaces U.S. as China's largest trading partner
2005	Trade dispute regarding Chinese textile and clothing exports ("bra war") EU-China partnership for climate change
2007	Begin of negotiations on a EU-China partnership and cooperation agreement
2008	Establishment of EU-China strategic economic dialogue
2012	EU-China year of intercultural dialogue

Source: Own research.

EU-China bilateral trade (mn euro)



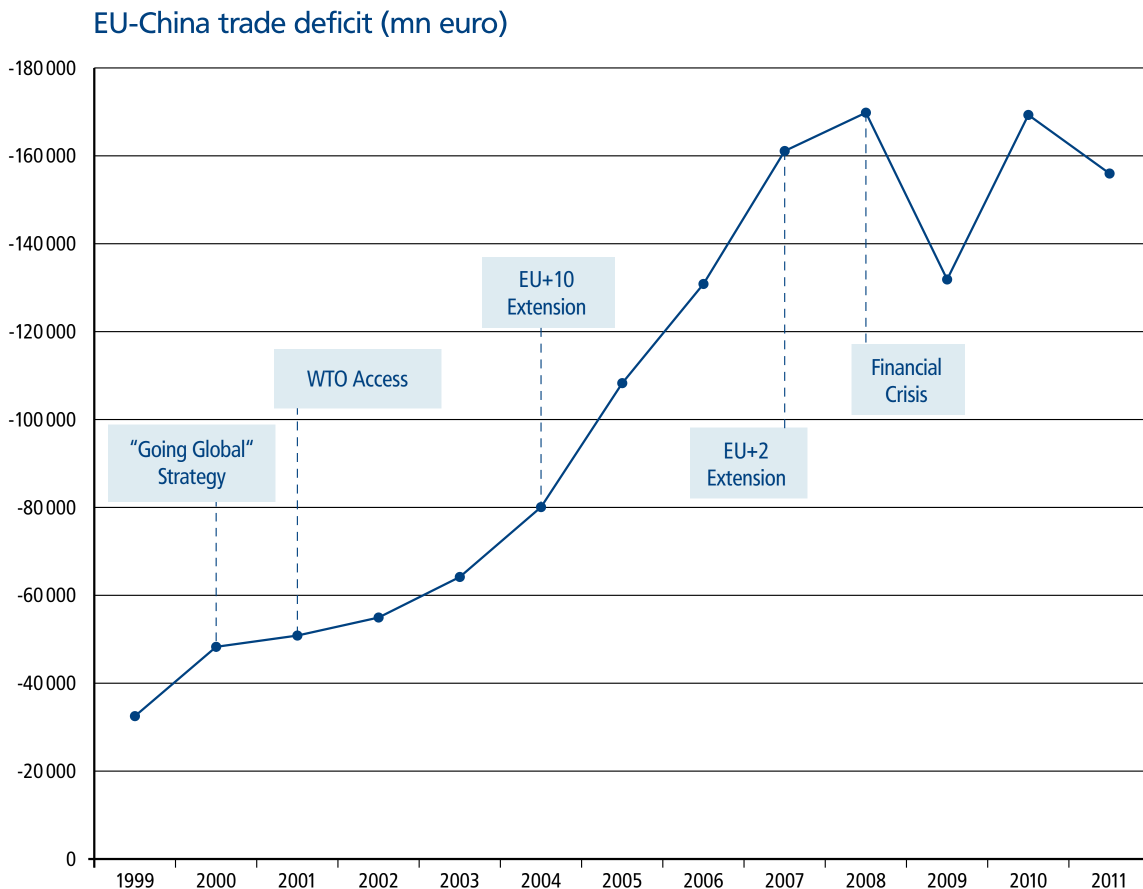
Source: Eurostat.

The financial crisis strongly impacted bilateral trade, serving to ease the previous imbalances slightly: Whereas imports from China sharply dropped in 2009, exports to China experienced unprecedented growth. EU export-oriented nations such as Germany have benefited from this development, and were able to stabilize their crisis-ridden economies more quickly than other member states.

Whereas bilateral trade shows a pronounced bias toward exports from China, the reverse is true of FDI outflows from China. Chinese FDI to the European Union amounted to only 1.7 percent (€0.9 billion) of total inflows in 2010, whereas European FDI to China accounted for as much as 20 percent (€7.1 billion) of total outflows. Reciprocal FDI flows are thus strongly biased toward FDI from the EU to China.

Historically speaking, China's low levels of outward foreign direct investment (OFDI) were due to a dearth of foreign exchange and the fear of an unrestrained outflow of capital. From the 1980s onward, the Chinese government successfully sought to attract foreign capital (yinjinlai), while at the same time restricting outflows (zouchuqu). According to the U.N. Conference on Trade and Development (UNCTAD), China's inward foreign direct investment (IFDI) volume ($105.7 billion) ranked third worldwide after the European Union ($304.7 billion) and the United States ($228.2 billion) in 2010. Since a large proportion of the IFDI attracted by China to date has been export-oriented, Western multinational enterprises (MNEs) effectively contributed to creating the current trade deficit. Indeed, according to China's Ministry of Commerce (MOFCOM), about 52 percent of China's 2011 exports originated from foreign-funded or foreign-owned firms.

OFDI from China did not play an important role in China's reform policy until after the introduction of the so-called Going Global Strategy (GGS, zouchuqu zhanlüe) in 2000. Since that time, China has engaged in a



Source: Eurostat.

catching-up process with respect to OFDI. From the government's perspective, this will ultimately increase China's international competitiveness, reduce export dependency and strengthen domestic demand.

II. Tensions and benefits – both sides of the story

China's huge trade surplus with the EU-27 constitutes one of the core issues in EU-China relations. From the European perspective, this deficit has not been the result of fair and free trade, but is due to distorted competition induced by strong state involvement within the Chinese export sector. The Chinese government has traditionally favored an export-oriented development model and has set policy incentives accordingly: Chinese companies are granted cheap credits, subsidies and tax relief, which enables them to sell products at artificially low prices on international markets. Western critics assert that this amounts to "dumping."

In the investment arena, continuous tensions have been associated with discrimination against European companies in China as well as the widespread prevalence of counterfeiting. Special regulations governing foreign investment, for example, may induce involuntary technology transfer. Investors are often required to disclose their blueprints and other sensitive information. In many cases, Chinese incumbents have been able to access this information and use it to establish their own competitive advantage. EU firms also face discrimination within the public procurement market, which is extremely difficult for foreign firms to access. Counterfeiting remains a general and persistent worry, making many companies hesitant to deploy their latest technology in China. Addressing these issues, Marielle de Sarnez, a member of the European Parliament and author of the resolution cited

above, said: "We have to protect EU businesses from problems such as trade barriers, counterfeiting and monetary dumping." Chinese OFDI to the European Union, even at its current low volumes, has recently created new tensions, as European countries feel there is a lack of transparency regarding the ownership and motives of Chinese companies.

From the Chinese point of view, Western partners seem to have double standards when it comes to trade and investment, with much depending on whether the investor's underlying political system is a democracy or not. In anti-dumping cases, economic factors such as market clearing prices and cyclical price declines appear to be overlooked. Moreover, some trading partners of the European Union and the United States appear to be more equal than others, even though WTO rules – by and large a Western construct – generally prohibit discrimination. Of course, China has not yet been recognized as a market economy by the European Union and the United States, and thus may be treated differently even under the WTO regime. China has always regarded this situation as a major flaw in mutual relations, and the Chinese government holds that the country today fulfils the necessary requirements for equal treatment. Similarly, the level of state involvement in the Chinese economy is regarded as having been exaggerated by foreign observers. By investing in the European Union, Chinese companies are increasingly seeking access today to state-of-the-art technology, strategic resources and new markets. In doing so, they face a variety of difficulties such as non-tariff trade barriers, overly biased media reporting and actual prejudice against their products and firms. For China, it is hard to understand how the European Union can constantly encourage – and even demand – Chinese investment in support of Europe's economy during the euro crisis, while China is at the same time suspected of perpetrating political infiltration by means of government-backed corporations.

Clearly, tensions between the European Union and China are manifold and will not be easily resolved in the near future. It is therefore essential to bear in mind the benefits both sides have received as a result of bilateral trade and investment flows.

European countries have been able to enhance their overall economic structure. They have outsourced labor-intensive portions of industries showing profit declines (e.g., apparel and textile production) to China, and have themselves moved toward high-end production and services. The global division of labor has become more sophisticated, allowing for the provision of increasingly inexpensive consumer goods. China's huge pool of inexpensive workers served as an important prerequisite for this development, while European firms seized the opportunity to optimize their cost structures and global supply chain.

Chinese investment in the European Union has meanwhile contributed to creating or safeguarding jobs and to enhancing productivity growth. European firms acquired by Chinese incumbents gain support for expansion within the Chinese market, which remains a very difficult task especially for small and medium-sized enterprises. Moreover, Chinese companies tend to be interested in long-term investment and strategic commitment to a location rather than short-term financial investment; this ought to make them welcome in European countries. This said, China's investment in the EU remains marginal, and its overall effect should not be overestimated.

For China, bilateral trade and investment with the European Union has been beneficial

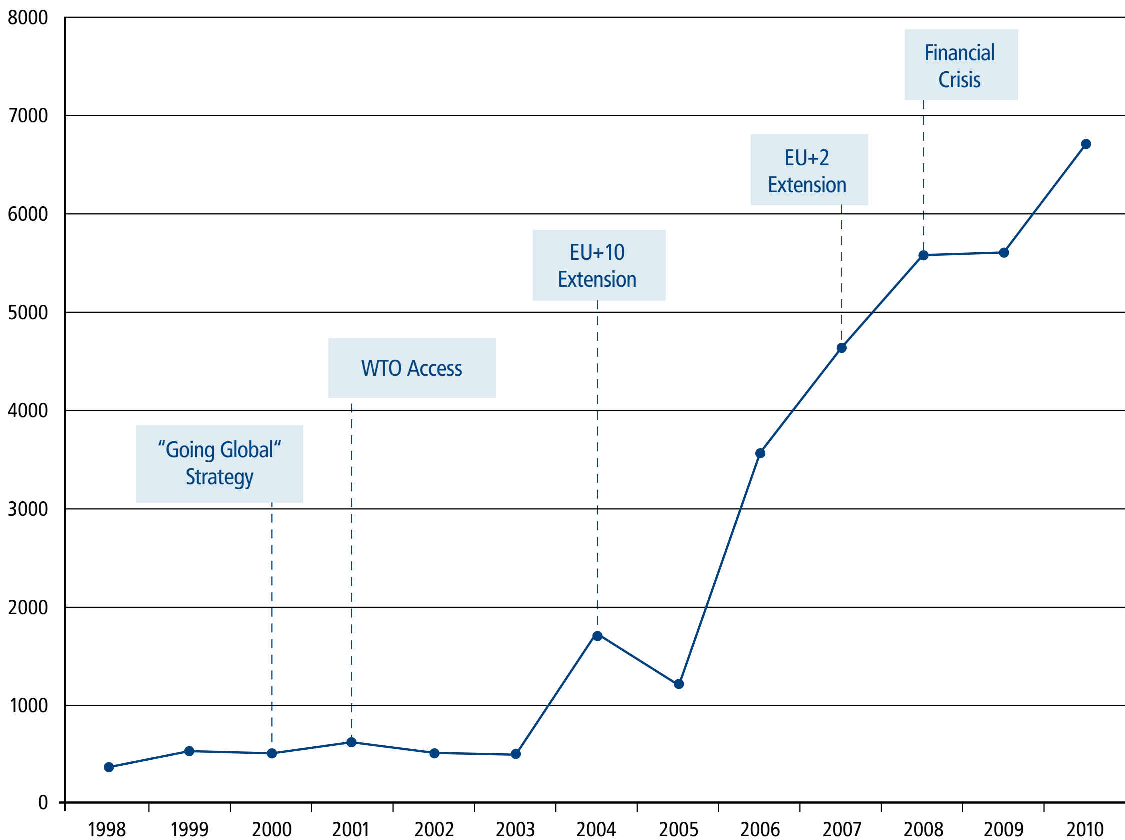
Top trading partners of China and the EU in 2011

EU's top three trading partners		
1.	US	445 bn. €
2.	China (without Hong Kong)	429 bn. €
3.	Russia	308 bn. €

China's top three trading partners		
1.	EU	567 bn. $
2.	US	447 bn. $
3.	ASEAN	363 bn. $

Source: Eurostat; China Customs (total amount of imports and exports).

China's FDI stock in the European Union (mn euro)



Source: Eurostat.

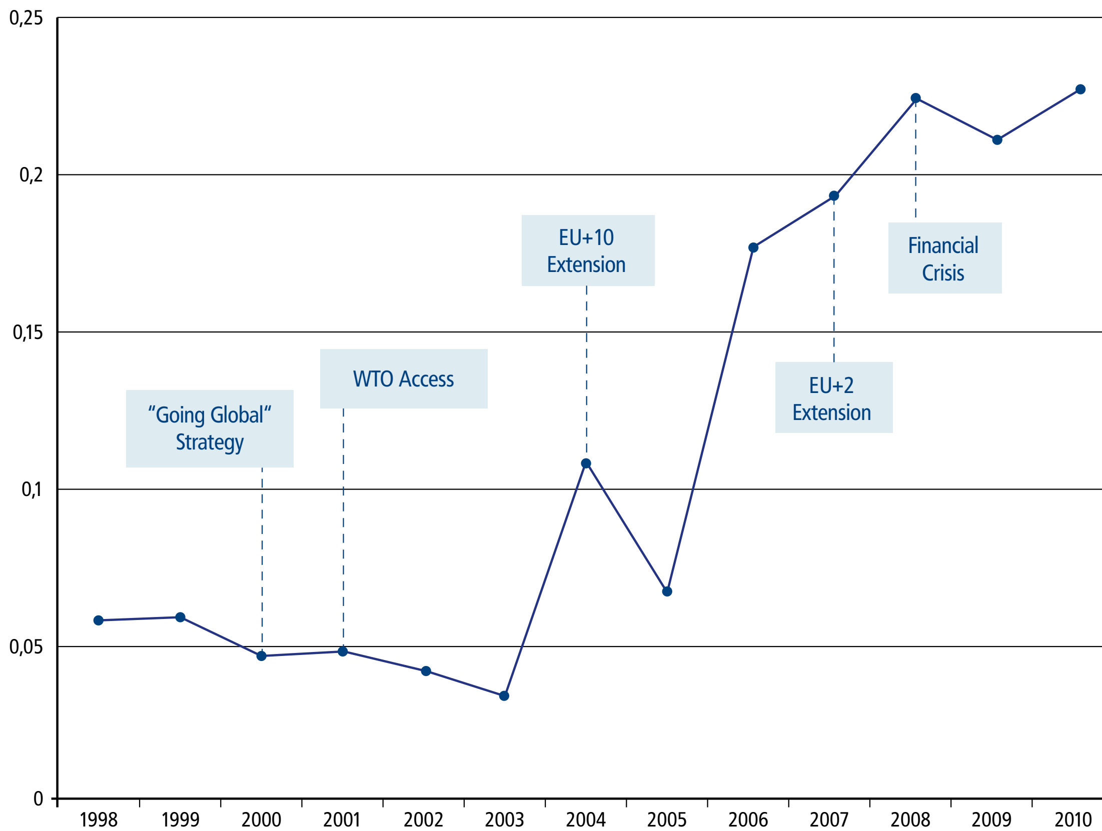
in several ways. Its national economic structure has undergone a remarkable transformation in the last three decades, during which time China's population has seen an unprecedented rise in living standards. Foreign trade and investment have been significant contributors to this development. They have accelerated the pace of industrialization, especially in regard to consumer goods, and contributed to the development of the service sector. China's export-oriented model has ensured a steady influx of previously scarce foreign currency. Today, China holds the world's largest foreign reserves ($3.2 trillion as of December 2011). The continuous flow of IFDI has created millions of jobs for educated urban workers, as well as for the surplus rural laborers who have poured into the cities since the mid-1980s.

Cooperation with foreign partners has given Chinese firms the opportunity to acquire modern international management skills and learn to operate under market conditions. Western technology has moreover helped China narrow the "technological gap."

III. Europe and China, increase openness and transparency!

In general, China's leadership has embraced the concept of free trade and investment, and has gradually liberalized China's economy without losing sight of the country's current stage of development. On March 18, just two months before the EP resolution cited above, China's National Development and Reform Commission (NDRC) published its "Suggestions on the 2012 Working Focus for Deepening the Reform of the Economic Structure." This document, which outlines important steps toward the implementation of the 12th Five Year Plan (2011 – 2015), explicitly advocates the "promotion

China's share of total FDI stocks in the EU (percent)



Source: Eurostat.

of a balanced development in [foreign] trade (cujin maoyi pingheng fazhan)." This shows that China recognizes and is willing to tackle trade-related issues, but that this will take time. The EU should actively encourage China to broaden its open door policy, but should also accept a pace of adaptation that is both set by China itself and is suitable to the country's specific situation.

In this context, the EP proposal to introduce tighter controls on foreign investment, with particular emphasis on investment from China, sends the wrong signal. The resolution states that "an EU monitoring body, similar to the review board in the U.S., would provide a coordinated, advance evaluation of foreign strategic investment." The Committee on Foreign Investment in the United States (CFIUS) is one of the most important regulatory bodies in regard to foreign investment in that country. Traditionally, CFIUS does not investigate FDI randomly, but rather scrutinizes cross-border mergers and acquisitions (M&A) only in strategic industries, in which foreign ownership might threaten national security. Beginning in 2007, however, CFIUS has been required to pay closer attention to foreign governmental involvement in FDI. Several takeovers proposed by Chinese companies, including of private firms in the United States, have since that time failed due to CFIUS intervention. These experiences have led many in China to believe that Chinese investors are being treated unfairly, and that Chinese M&A transactions are among those most likely to receive the greatest scrutiny.

Due to their country of origin, Chinese firms are generally suspected of holding a secondary political agenda, even though several recent studies on Chinese OFDI, including one performed by the Bertelsmann Stiftung, have found that economic incentives are stronger than any political motivations.

The European Union thus ought to think twice before resorting to measures similar to CFIUS, as these would only confirm China's

impression that some EU trading partners are being treated differently than others. In addition, the EU – a global model of economic liberalization and integration – would in this case set a bad example, which instead of securing reciprocity in trade and investment would risk triggering a vicious circle of reciprocal protectionism.

In turn, China must take EU concerns seriously, and do more than simply try to tough things out. It is time for China to take a step toward her strategic partner and show that the partnership is more than simply rhetorical, at least in regard to trade and investment. In some strategic industries, foreign firms are still obliged to establish a joint venture with a Chinese partner in order to participate in the Chinese market. Frequent intellectual property violations constitute an additional risk for foreign investors in China. As both have been pressing issues for years, China should move far more decisively toward abolishing forced joint ventures and protecting intellectual property rights.

Public procurement is another of the EU's major concerns. At the core of the EU criticism lies the unequal treatment afforded to European and domestic firms within China's public procurement system, which is marked by a lack of transparency and competition. Though China entered negotiations for accession to the WTO Government Procurement Act (GPA) in 2007, progress thus far has been slow and unsatisfactory from the perspective of the GPA parties.

Instead of passively waiting for China to become a part of the GPA regime, an eventuality that holds uncertain actual promise, the EU could take a proactive step and seek to deepen cooperation in the realm of public procurement. For instance, a common platform could be created, perhaps in the form of an online gateway translated into Chinese and the major EU languages, which brings together potential contract providers and suppliers from both regions. Transparency and competition could thus be enhanced in the long run. Discrimination against foreign firms might be tackled through the establishment of a common committee for the evaluation of suppliers' bids. The platform could initially be launched as a small pilot project, restricted to specific industries or projects, and – if successful – be gradually extended in the future. China's successful recipe for reform – "crossing the river while feeling the stepping stones" (mozhe shitou guohe) – could help to get this process started.

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Further reading:

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