

The EU Trade Policy towards China

Patrick Messerlin

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October 24, 2007

Draft – Comments welcome

EXECUTIVE SUMMARY

Designing its trade policy towards China, Europe should exert extreme foresightedness. Rather than to be trapped in bilateral trade balance conflicts (economically meaningless and politically hopeless), the EU should push for objectives that are attractive to its own interests, and to Chinese interests – China's economy is already too large to be influenced exclusively from outside. In this perspective, the paper offers five main proposals.

- Concerning trade in goods, the EU should aim at a 'joint better enforcement' of China's WTO Accession Protocol – granting China the market economy status in antidumping investigation while getting from China clarification, confirmation, and other marginal improvements of its tariff schedule as back.
- The EU should narrow down its requests on intellectual property rights to limited range, which deliver true innovations and benefits to both European producers and Chinese consumers.
- The EU should focus on services and foreign investment, by proposing an early and progressive elimination of the special safeguard instrument against Chinese exporters in exchange for additional commitments from China in services and investment.
- The EU should re-focus its trade policy on the WTO, away from bilateral trade agreements. Such agreements amplify incentives among Asian countries to negotiate bilaterals between themselves, by the same token risking further marginalizing the EU. And they tend to segment even more the Chinese provincial markets, while the WTO approach would reinforce the emerging 'Chinese Single Market'.
- Improving the functioning of its domestic markets would make the EU more resistant to the increasing size of the Chinese economy, for instance, in the energy or financial sectors.

Such an ambitious program has no chance to succeed if it does not fill two conditions. First, it should keep a clear economic focus. Trade negotiators are not credible when they tackle political issues. Second, the EU should work with other players in the world. As such cooperation should not be perceived by China as an aggressive coalition, it should involve a notable group of countries. It is thus important for the EU to go beyond the US and Japan, and to ensure the participation of medium-size countries in this cooperation. A key benefit of the presence of such medium-size countries is that they are often among the best ones in terms of governance – the great challenge faced by China, and consequently, by the entire world.

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The EU trade policy towards China is not simply about shaping key economic relations with an emerging super-power. It is also a surrogate of the EU foreign policy in this part of the world for the next two decades since the European Union (EU) is unlikely to develop a fully fledged foreign policy in the region within such a short time-span.

Strong asymmetries make the design of the EU trade policy towards China a daunting challenge. First, China (like the US) has a foreign policy, allowing its trade policy to be more of a “business as usual” type, and to be only occasionally the continuation of foreign policy by other means. By contrast, the EU cannot counterbalance a tougher stance on trade by concessions in foreign policy matters, or vice-versa – a key aspect to be kept in mind when looking at the latest developments in the EU-China-US relations. Second, Europe will still be the larger and richer economy during the next twenty years. Hence, it will bear more responsibility than China in building sound future bilateral relations – like the US did with Europe from the late 1940s to the early 1960s, when Europe was hesitating between market economy and central planning, and their associated political regimes. Last but not least, Europe will be a “diminishing giant” during these two decades. Such an evolution is relative: Europe will continue to become richer, while China will catch up, a positive development since nobody could be satisfied with an eternally poor China.¹ Meanwhile, the EU may have hard times to resist to the temptations of exploiting short-lived advantages “when it is still time”, while rising China may be tempted to procrastinate until it could enjoy its full strength in the world forum.

¹ The US faced the same challenge in the Second World War aftermath. Interestingly, the US is still 15-25 percent richer than Europe (on a per capita basis). The only difference with the US-EC parallel may be the pace of the changes, although section 1 suggests some *caveats* in this respect.

In such extraordinary circumstances, Europe (the EU and its Member States) should choose carefully its objectives, and, for each of them, evaluate thoroughly the opportunities lost when insisting too long and/or too much. A key criterion should be to check whether an objective envisaged could attract the support of Chinese interests or not – the Chinese economy is already too large to hope to influence it only from outside. For instance, fighting for lower peak Chinese tariffs in goods, or for a more moderate and uniform protection in services and in investment are goals that will find positive support among large parts of Chinese economy and society, in sharp contrast with a substantial range of intellectual property rights, such as copyrights in audiovisuals. In short, Europe should exert foresightedness, and not hesitate to behave vis-à-vis China as it would like China to behave vis-à-vis Europe in two decades from now.

These many goals are awfully difficult to achieve via trade policy, a policy often driven by short-termism rather than by strategic views, by restless pressures by narrow domestic lobbies rather than by a global approach, by unbalanced requests to the partner rather than by a sense of joint concessions in order to get joint benefits.

These goals may also seem utterly naïve, and they certainly do not fit the mood prevailing in Brussels since mid-October 2007 – a point examined in more detail in the paper conclusion. But, many European firms are investing in China although they are getting lower returns from Chinese markets than from other places in the world. They ultimately do so because they are convinced that sacrificing some short term profits is necessary for becoming part of the Chinese economy and society – hence the apparent oxymoron of “competition and cooperation” often used by European businessmen when describing their relations with China.

The brief is organized as follows. Section 1 puts the setting by assessing the current role of China in the trade system – much more important than often said – and by getting a sense of China’s development in the coming decades – more much promising and complex than often believed. Section 2 focuses on trade in goods. The current EU trade policy towards China in this domain is torn apart between defensive reactions and good intentions, and the brief suggests innovative options. Section 3 shifts to the wider, more difficult but more promising, “behind-the-border” agenda (intellectual property rights, services, investment, norms). These are the topics that will require the most dramatic decisions from the EU, both in terms of focus and depth. Section 4 looks at the emerging interactions between trade and foreign

policies in Africa and in Asia. It argues that Europe's current tactic favoring preferential trade agreements is a strategic economic and political mistake. The brief concludes by putting the EU trade policy towards China in a truly global context involving the US and a few other countries as key partners.

SECTION 1. SETTING THE SCENERY: TODAY AND TO-MORROW

This section assesses the full role of China in the world trade system by putting forward some aspects often disregarded. Then, it provides a picture of the Chinese economy that strongly suggests that the European fears generated by the Chinese growth are exaggerated, while the benefits from such a growth are underestimated.

China's systemic role in the world trade regime

Since a few years, China is often criticized as having a disappointing low-key trade policy, particularly in the Doha Round negotiations. This view is not an accurate assessment of the situation.

First, it is important to understand how China's tariff liberalization has been ambitious, in terms of pace and magnitude. It took only twenty years for China to cut its average tariff from 60 percent (1985) to less than 10 percent (2006) – less than 3 percentage points above the current EU level (see Table 1). Maximum tariffs give a better view of what has been achieved from an economic perspective because they are the tariffs that impose the largest distortions in an economy, hence the largest welfare costs on domestic consumers. In a few years (2001-2006) China has reduced its maximum bound industrial tariffs by almost half, bringing them closer to the EU level in most industrial sectors. In agriculture, China has reduced its maximum tariffs by half, bringing them to a lower level than the EU, despite the fact that two-thirds of the Chinese population still heavily rely on agriculture. These rapid pace and magnitude explain, if not justify, today problems in Chinese tariffs.

Table 1. China's unilateral tariff liberalization, selected sectors

	Average tariffs (%)			Maximum tariffs (%)		
	China 2001	China 2005	EU 2006	China 2001	China 2005	EU 2006
Agricultural products	23.1	15.3	17.8	121.6	65.0	427.9
Manufacturing products	14.4	8.8	3.8	90.0	50.0	50.9
Chemicals	9.9	6.7	4.3	50.0	47.0	50.9
Wood, paper	12.2	4.3	2.5	38.0	20.0	10.0
Textile	) 21.1	9.7	7.4	) 42.0	38.0	12.0
Clothing	)	16.2	10.8	)	25.0	12.0
Leather, Shoes	17.4	12.2	7.4	90.0	25.0	17.0
Machinery	13.4	8.0	2.1	45.0	35.0	14.0
All products	15.6	9.8	6.9	121.6	65.0	427.9

Source: WTO Secretariat, Trade Policy Monitoring Reports: China (2006) EU (2007).

Second, China's massive tariff liberalization has had an indirect, but strong, disciplining effect on the level of tariff protection in other developing countries. When acceding to the WTO, China breached the three taboos of a typical developing country's trade policy – keep high tariffs, don't bound tariffs, liberalize as slowly as possible. By shifting to moderate and bound tariffs at a rapid pace, China has indirectly left little choice to India and other emerging economies. If these countries want to attract traders and investors from the rest of the world, they have to offer tariffs roughly similar to Chinese tariffs. China has done unwittingly more for the trade liberalization of India and other emerging countries than the EU and the US during the past twenty years of multilateral negotiations – to the benefit of the rest of the world, including the EU.

Third, in the current Doha negotiations, China's membership to the so-called "G20" coalition has been key for the sustainability of this coalition which consists in 20 (or so) key emerging and developing countries. The G20 was established before the WTO Cancun Ministerial for fighting the US and EU opposition to freer trade in agriculture, and it has been the main interlocutor of the US and EU since then. A G20 without China would have lost 40 percent of its GDP size (at power-purchasing parity), half of its (GDP weighted) growth rate, and many negotiating topics tabled by the G20 (hence narrowing the scope of compromises).

China or Chinas? The Tale of the "Three Chinas"

A decade ago, a few Chinese economists hoped that China's accession to the WTO would not only be a liberalization process vis-à-vis the rest of the world, but also a driving force for

eliminating or reducing trade barriers within China – as the GATT did for the EU internal liberalization during the 1960s to the 1980s.²

A broad sense of China’s economic diversity is essential for a better assessment of the competitive pressures that China will exert on the EU (and world) economy in the coming decades, and of the opportunities that China is offering to European (and world) exporters. The following map visualizes the three different groups of provinces that can be defined on the basis of the provincial GDPs per capita, while Table 2 presents the figures allowing a more detailed comparison with the EU Member States.

With their 420 millions of inhabitants, the nine richest Chinese provinces are roughly as populous as the whole EU. Representing more than half of China’s GDP, they already enjoy a GDP per capita higher than 9,000 USD in purchasing power parity (PPP) terms, making them richer than or as rich as fourteen EU Member States, with Shanghai similar to Cyprus and Liaoning similar to Bulgaria (see Table 2).



² The EU and China are very close in themes of economic heterogeneity [Messerlin 2007] and face similar difficulties in building their own respective “Single Market”, as illustrated in 2007 by the emergence of a Southern Chinese regional economic bloc around Hong Kong as a counter-balance to Shanghai’s influence (see map) .**

Table 2. EU and China's GDPs per capita

				Classification	
EU Member States		Chinese Provinces		World Bank	WTO
Luxembourg	69961			High income	Zone of developed countries
Ireland	38827				
Austria	32276				
Denmark	31914				
Netherlands	31789				
Belgium	31096				
Britain	30821				
Finland	29951				
Sweden	29541				
France	29300				
Germany	28303			Upper middle income	Zone of developing countries
Italy	28180				
Spain	25047				
Cyprus	22805				
Greece	22205	Shanghai	22993		
Slovenia	20939				
Portugal	19629				
Czech Rep.	19408				
Malta	18879				
Hungary	16814	Beijing Tianjin	15423 15394		
Slovakia	14623			Low middle income	Zone of Least Developed Countries
Estonia	14555				
Lithuania	13107	Zhejiang	12803		
Poland	12974	Jiangsu	11139		
Latvia	11653	Guangdong	10384		
		Fujian	9269		
Romania	8480	Shandong	9072		
Bulgaria	8078	Liaoning	8763		
		Heilongjiang	7469		
		Hebei	6924		
		Nei Mongol	6116		
		Xinjiang	6025		
		Jilin	5871		
		Hubei	5639		
		Hainan	5057		
		Shanxi	4904		
		Henan	4877		
		Qinghai	4645		
		Chongqing	4589		
		Hunan	4505		
		Jiangxi	4387		
		Ningxia	4210		
		Shaanxi	4185		
		Xizang	4150		
		Sichuan	4040		
		Anhui	4005		
		Guangxi	3651		
Angola		Yunnan	3603		
		Gansu	3200		
Vietnam		Guizhou	2192		
				Low income	

Source: World Development Indicators, 2004

Note: GDPs per capita are on a PPP basis.

These basic facts suggest two essential conclusions from a trade policy perspective. First, these nine provinces which represent 85-90 percent of current China's external trade and inward foreign direct investment are losing fast their previous comparative advantages based on low wages, meaning that the competitive pressures that they will exert on the European economies will be much less based on basic price competition. Rather, their future growth will depend upon the quality and the variety of their products, their capacity to innovate, and the quality of their industrial relations.

Second, the population of these nine provinces is rapidly developing the taste for products and services similar to those consumed in Europe. Trade and investment opportunities available in China will no more be limited to equipment goods and luxury consumer products. They will expand to 'normal' consumer goods, with a market of a size equivalent to Spain to Italy in the short run at current exchange rates) to another EU in the longer run.

That said, the rise of the Chinese average income hides a huge difference between these nine provinces and those lagging behind remains huge, with the poorest one (Guizhou) having an average GDP per capita similar to Vietnam (at current exchange rates). The other 22 Chinese provinces can be divided in two tiers of almost equal size in terms of population and GDP. Nine provinces have a GDP per capita higher than US\$ 1000 – they would be considered as "developing" economies in the WTO forum. The thirteen remaining provinces have a GDP per capita equal or lower than US\$ 1000 – they would have the "least-developed economy" status in the WTO forum.

Predicting what will happen to these 22 provinces during the two or three coming decades is difficult. Some of them will follow in the nine richest provinces footsteps with some lag and/or at a slower pace. The rest of the provinces may be constrained by long term structural weaknesses, as in any continent-wide economy, meaning that the competitive pressures they will exert on the world economy will be weak, and that they may be a drag on the Chinese economy and society.

In short, these observations capture a much more promising and complex picture of the Chinese economy. First, it becomes rapidly misleading to perceive the economies of the EU and of the nine provinces as 'complementary' and dominated by 'price-cutthroat competition' (as is still often done in Europe). These economies are becoming fast similar, both in terms of

consumption and production pattern. Second, as a result, a potential market of the EU size is emerging in China for all the goods and services produced in Europe – and not only for the equipment but also luxury goods as until now. Unfortunately, the more confrontational EU stance occurs precisely at this time. Lastly, depending on the number and size of the structurally weak provinces, pressures on the world economy that the nine Chinese richest provinces have exerted during the last two decades may decline, whereas the domestic pressures on the Chinese economy and society may rise. Such pressures could be dramatic if a speculative bubble ‘à la Japonaise’ occurs in the short run in China.

SECTION 2. TRADE IN GOODS

Until 2004, the EU-China trade relations were shining for three reasons. First, the 1985 EU-China Trade Agreement clearly granted to China the “most-favored-nation” status, extending to China most of the EU concessions granted to the other GATT (WTO) Members. This was in sharp contrast with what happened between China and the US. From 1989 to 1999, the US Presidents had to fight every year with the Congress for renewing the MFN status even to use president’s veto – an ordeal that left Beijing bemused by the US constitutional hurdles, and ultimately suspicious.

Second, the negotiations on China’s accession to the WTO were very long (fifteen years) and difficult. Europe had the luxury to be soft on China because it could count on US muscles to extract concessions from it. The US-China agreement (November 1999) on China’s WTO accession was concluded six months before the EC-China agreement, and it already contained all the key provisions that, later, were included in China’s final WTO Accession Protocol. In fact, the EU was able to get from China only limited additional tariff cuts (on 150 products, mostly beverages, cosmetics and machinery) and slightly better market access in retail (lift of the joint venture restrictions on large department stores) insurance (seven new licenses) and telecommunications (speeding up the market opening).

The EU imports from China became increasingly visible during the late 1990s and early 2000s. But, until 2004, their composition (labor-intensive industrial products) and growth gave an impression of “*déjà vu*” – the usual story of an emerging dynamic economy during the last fifty years. Meanwhile, the EU trade deficit with the world remained modest (0.6

percent of its GDP, compared to 5.1 percent in the US case). As a result, until 2004, EU officials were under less pressure to act on China's trade than their US counterparts.

Entrenched EU sectoral protection

Even during these honeymoon years, a few EU sectors have tried hard to stop Chinese exports to Europe. As it could be expected, these sectors were labor-intensive (clothing, shoes) or simply skilled in capturing European (and US) protection (steel and chemicals).

An ongoing flow of protectionist measures

Antidumping measures have always been the EU preferred 'trade defense' instrument vis-à-vis the emerging economies, and China is no exception. The EU has reduced by a third its annual number of antidumping cases against the world in 2002-2006, compared to 1995-2001. But it has kept constant the number of antidumping initiations against China (roughly 6 cases per year for each period). The number of EU antidumping cases per US\$ billion of EU imports also shows a substantial discrimination against China, with a figure for China twice higher than the one for the world, despite a larger increase of EU imports from China, compared to the rest of the world.

In 2002, the EU began to use another trade defense instrument, "safeguards", against Chinese steel exports. Safeguards are characterized by potentially much wider product coverage than antidumping. For instance, the first EU safeguard against Chinese steel was equivalent to at least 10 antidumping cases – a feature to take into account when observing the apparent stability of the EU antidumping activity [Kommerskollegium 2004]. The EU safeguard in steel covered many more countries than China, and it was decided a week after a similar US safeguard. But, it sent a negative message, quickly understood by Indian steelmakers which have swiftly invested in the EC steel sector, hence getting access to European-Japanese global alliances (ArcelorMittal with Nippon Steel) and ultimately amplifying the risk of future EU protection against Chinese producers. It is thus not surprising that steel was again a source of tensions during the June 2007 EU-China Trade Ministerial Meeting.

In 2005, a second safeguard (under a specific provision of China's WTO accession protocol) was launched against a wide range of Chinese exports of textiles and clothing, from cotton

fabrics to men's trousers to brassières to flax or ramie yarn. The subsequent negotiations ended up in "voluntary export restraints" (VERs) consisting in growth caps re-imposed on EU imports from China for 10 out of the 35 categories of textiles and clothing (that is, a measure equivalent to many antidumping cases).

Despite the apparently 'friendly' negotiating mode, these VERs have had four major negative effects. First, these measures were a serious blow to the ban of VERs included in the 1995 Uruguay Agreement on Safeguards. Second, they have resurrected a large chunk of the Uruguay Agreement on Textile and Clothing (ATC) which was eliminated only a few months before (December 31, 2004) and which gave to EU producers ample time (the ten years from 1994 to 2004) for adjusting to increased competition from developing countries. Third, these VERs were imposed on a retroactive basis, freezing huge amounts of Chinese exports in Chinese and EU ports and generating an embarrassing "*bra war*" between outraged European retailers and the EU Commission. Last but not least, although these VERs are expected to be abolished in December 2007, there remains the legal possibility to extend them until December 2008 and/or to widen their scope to other textile and clothing products. Indeed, the EU and China just agreed on not imposing quotas for 2008, but on monitoring 8 (out of the 10) categories (T-shirts, pullovers, men's trousers, blouses, dresses, bras, bed linen and flax yarn) with the possibility to reverting to using new safeguard measures if imports rise 'dramatically' before the end of 2008 [International Herald Tribune, October 10, 2007].

A welcome freeze, but for how long?

Since January 2007, no antidumping case has been initiated by the EU, raising furor in the European industrial quarters most addicted to this instrument. However, such a complete standstill is so extreme that it is hardly sustainable. It can be quickly reversed at any time (particularly after the end of the ongoing review of the EU trade defense procedures). But this freeze offers an opportunity to look for an economically and politically sound alternative to the past trade defense actions. Such an alternative should rely on four observations.

First, economic analysis shows that, except for a tiny proportion (roughly 5 percent of the cases) the so-called "trade defense" measures (be antidumping or safeguard) amount to plain

protection.³ Of course, the same conclusion holds for China's antidumping cases against EU exporters.

Second, past experience and economic analysis strongly suggest that such measures rarely protect the intended beneficiaries – workers or producers of the import-competing sectors [Messerlin 2001]. In fact, as repeatedly shown by the many European antidumping cases against Japanese or Korean firms during the 1980s and 1990s, antidumping measures enforced against firms from innovative emerging economies often induce foreign exporters to upgrade their products even more rapidly than they would have done in the absence of such measures – spreading even faster and deeper competition in Europe, and making more difficult the adjustment of the European import-competing firms.

Today trade defense measures have an additional flaw. They are based on an increasingly obsolete view of what a modern industrial economy is – a complex production process fragmented among a notable number of countries. The trade defense measures equate industry to manufacturing alone, ignoring the essential pre-manufacturing step (design and preparation of the physical manufacturing processes) and the post-manufacturing step (logistics, marketing, advertising, etc.). These two steps generate a lot of value added in the importing country.⁴ For instance, even in labor-intensive products such as shoes, these two steps represent half to three quarters of the European value added in the shoe sector [Kommerskollegium 2007]. In short, not only antidumping and safeguard measures do not protect the “old” economy (the manufacturing step *per se*), but they also hit badly the “new” economy (the pre- and post-manufacturing steps).⁵

Lastly, rather than helping domestic industries, the “trade defense” instruments generate unintended but huge rents for intermediaries – be traders or politicians. Moreover, they often

³ Antidumping and safeguard cases have been extensively analyzed by a host of economists and lawyers (for instance, see Bloningen and Prusa [2003], Mavroidis et al [2008]). Less than 5 percent of all the EU and US cases in the 1980s and 1990s would ultimately make economic sense from a competition policy point of view [Bourgeois and Messerlin 1998, Shin 1998].

⁴ Indeed, these measures have generated many tensions among the EU Member States, with an increasing opposition from the Member States where businesses have adjusted to modern commerce practices. These tensions have been made public by a joint op'ed signed by four EU Trade Ministers, a rather unusual initiative [van Gennip et al. 2005].

⁵ The number of Chinese antidumping cases against EU products per US\$ billion of imports of Chinese imports from the EU has slightly increased from 0.041 (1995-2001) to 0.049 (2001-2005) actions. However, the stock of China's antidumping measures in force in 2006 per US\$ billion of Chinese imports from the EU (0.140) is only half the stock of EU antidumping measures in force per US\$ billion of EU imports from China.

favor the pursuit of anti-competitive strategies by complaining firms, magnifying the costs of protection. For example, Philips and Osram (Siemens), the two biggest European producers of energy-saving lamps, launched a case against the Chinese lamp producers. Huge EU antidumping duties (31 percent on average, up to 66 percent) bankrupted the Chinese firms, and the EU firms became massive importers from China, to the point that Philips could no more be considered as a ‘domestic European’ firm. By doing so, they made a mockery of an icon of the EU energy-saving strategy (low-energy lamps) and a pillar of the antidumping procedure (the definition of a ‘domestic’ producer).⁶ These flaws of the antidumping procedure are particularly large in the case of the EU imports from China because the EU antidumping duties on such imports are particularly high – on average 39 percent, compared to 29 percent for those imposed on imports from the rest of the world.⁷

These economically sound arguments get a key political dimension in China’s case. Since 2006, antidumping has become a source of systemic friction between the EU and China. Since its WTO accession, China has forcefully tried to get the “market economy status” (MES) in antidumping investigations. Such a status would give to Chinese firms the same legal treatment in antidumping investigations than the one granted to almost all the WTO Members. In 1998, the EU made a first step in this direction by granting China the ‘transition economy status’, a status close to the MES except that it is granted only on a firm by firm basis and conditionally on restrictive and quite unpredictable criteria.⁸ In 2003, China made a formal request for benefiting from the MES. But, the 2006 working document spelling out the new EU-China trade relations from the EU Commission point of view still states that “*the conditions for granting MES to China are not fulfilled*” [Financial Times, June 12, 2007].

⁶ The Chinese government’s reply to EU’s trade defense instrument questionnaire mentioned that: “*The trade defense measures have even become tools for unfair competition by some multi-national companies. They make investments and profits in the exporting countries. Meanwhile, they apply for trade defense measures in the importing countries targeting products originated in the exporting countries with an objective to carving up different markets to pursue monopoly, which should not be tolerated.*”

⁷ Economic analysis shows that the welfare cost of tariff is a function of the square of the tariff; hence increase much faster when tariffs increase. The economic costs of the EU VERs for the European consumers are estimated to be roughly five times the amount that would have been necessary for compensating directly the European workers losing their jobs [Spector 2005].

⁸ The EU assesses the existence of a “market environment” with five criterias: (i) does the government influence the company’s operations? (ii) does the legacy of the plan economy, in terms of public ownership, barter trade, etc., affect the firm? (iii) does the firm operate under an effective company law, and does it have decent accounting standards? (iv) does the firm operate under an effective bankruptcy framework and property rights protection? and (v) does the firm convert currency at standard market rates? These criteria are loose – and how many EU firms would pass all of them?

Such a *statu quo* is generating increasing tensions in China which is now considering the issue as a matter of national pride.⁹

Shifting gears

The above economic and political arguments converge to suggest that the EU “trade defense” instruments should be subject to stronger disciplines. The increasingly serious threat that China could retaliate with its own antidumping measures should even convince a notable share of the current users of the EU antidumping instrument.

The minimal increase in EU disciplines would consist in granting China the MES status. Such a status would eliminate the most outrageous procedural biases in the antidumping cases against China – such biases would be simply unthinkable in any domestic fair legal process. That said, the EU could argue that granting the MES status consists in a better enforcement of its commitments associated to China’s accession to the WTO. The EU could accordingly offer to trade the MES status with a better enforcement by China of some of its Accession Protocol obligations – such as a clarification and/or a better enforcement of China’s tariff schedule (for instance, tariffs on auto parts).

Wider protectionist pressures

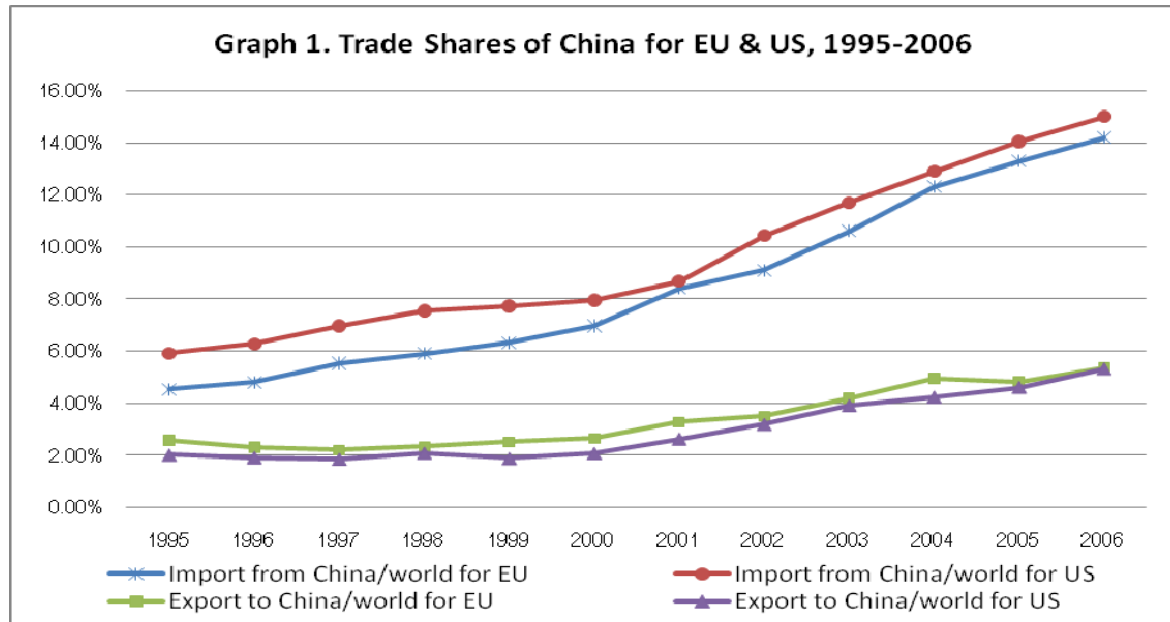
In the mid-2006, the EU Commission launched an initiative aiming at updating the EU-China trade agreement (for more detail, see section 3). However, the June 2007 Annual EU-China Trade Ministerial Meeting (hereafter the Ministerial) witnessed a “frank” (meaning tense in the diplomatic jargon) tone in the EU-China discussions, leading the EU Trade Commissioner to declare that *“I am not yet satisfied that the Chinese have grasped the scale of the problem”* [Financial Times, June 12, 2007]. Since mid-October 2007, the tone has been even more confrontational, with references to the ‘Chinese juggernaut’ in European official speeches and press conferences, and with European threats to launch cases at the WTO Dispute Settlement mechanism [International Herald Tribune, October 18, 2007].

⁹ In 2006, the Chinese Trade Ministry has pushed for a regulation permitting Chinese exporters to petition against their Chinese competitors exporting at ‘unfairly low prices’. This regulation was abandoned because of the fear that foreign firms established in China could use such a regulation for their own benefits.

Cloudier skies

This tenser tone echoes the evolution of the EU-China bilateral trade since 2004. It seems that nothing can stop the growing EU trade deficit with China that follows the same pattern than the US trade deficit with China (see Graph 1). In 2006, a symbolic Rubicon was crossed when China replaced the US as the EU's largest source of imports of goods.¹⁰ At the same time, the EU global (with the world) trade deficit increased to 1.5 percent of the EU GDP in 2006.

All these developments have induced the EU officials to look beyond the sectoral issues and to evoke unsustainable trade deficits. Until recently, EU officials have stopped short to refer to a yuan re-alignment. But, the euro zone finance ministers urged China to let yuan appreciate against other global currencies, while they keep murmuring the ever falling dollar and the ever rising euro, as well as domestic actions that these evolutions require urgently [International Herald Tribune, October 10, 2007]. In short, the EU trade policy towards China is “Americanizing” at a rapid pace.



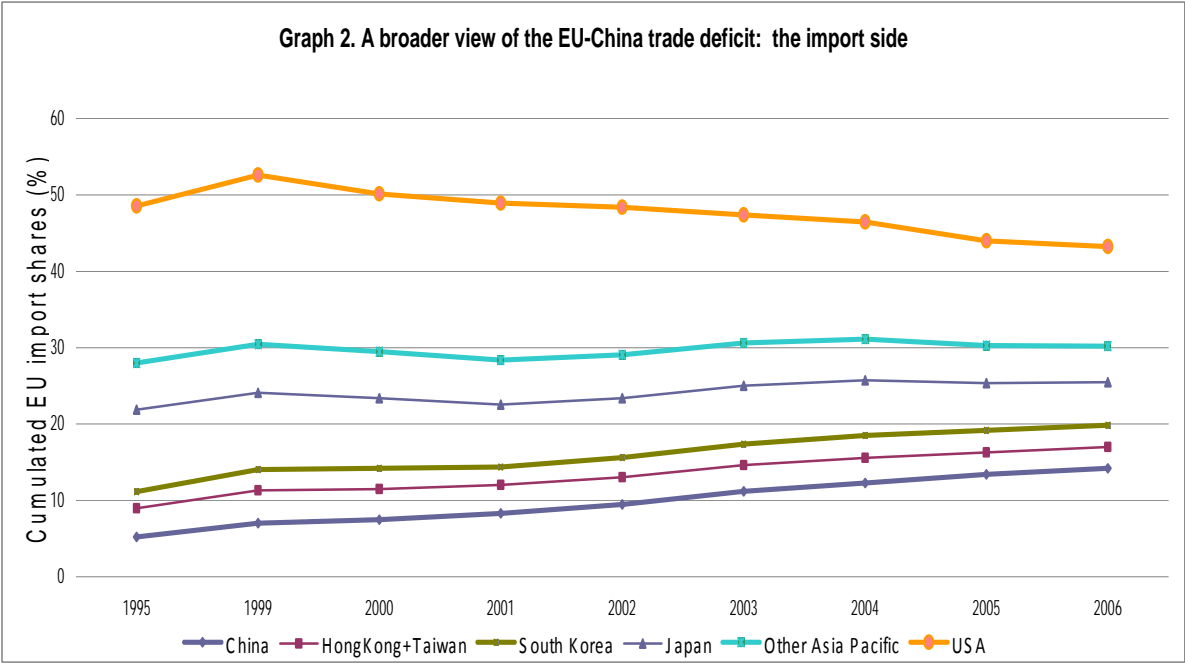
The EU trade deficit with China: “Plus ça change, plus c’est la même chose”¹¹

¹⁰ The importance of the capital flows between the EU and the US partly explain the changes in trade shares.

¹¹ “The more it changes, the more it is the same”.

Economic analysis shows that trade” deficits (be global or with a country) should be a matter of concern not for trade officials, but for macroeconomic policy-makers. In a nutshell, the trade balance of a country reflects its domestic savings-investment balance, and the similar balances of its partners. Simple evidence offers additional insights in the EU-China case.

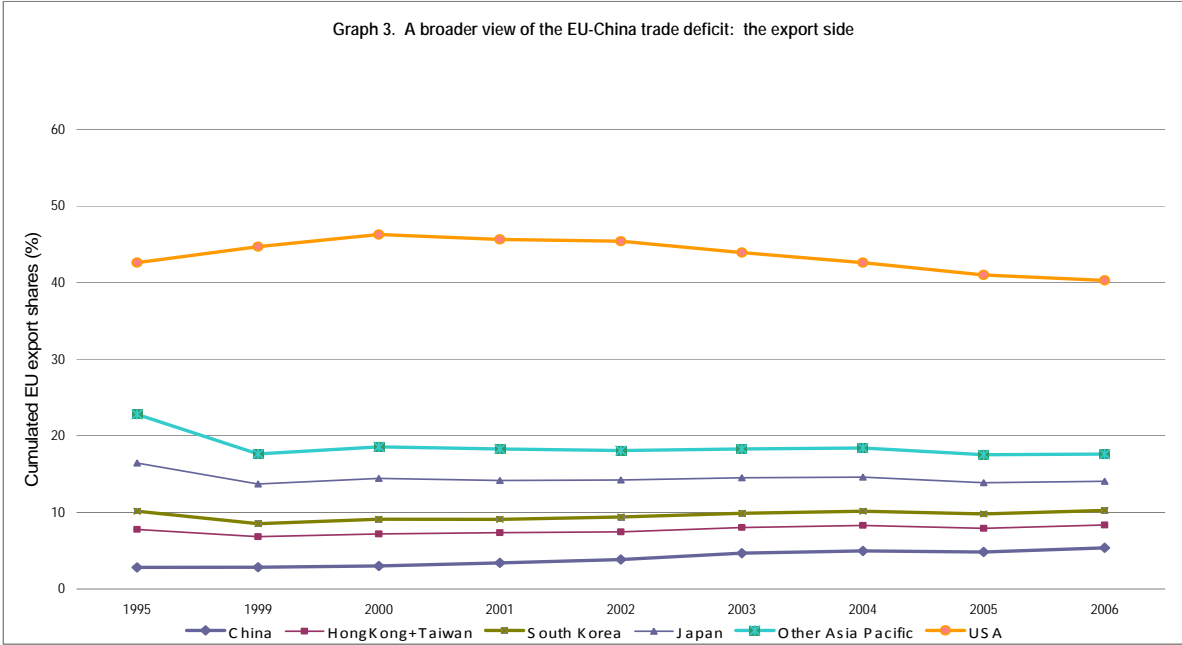
Graph 2 exhibits the cumulated imports from China and nine economies (Japan, South Korea, Hong Kong, Taiwan, Singapore, Thailand, Malaysia, Indonesia and the US) in 1995, and between 1999 and 2006. Since 1999, the import shares from these nine economies are squeezed between an increasing import share from China (the rising bottom curve) and from the rest of the world (the declining top curve). (Graph 2 excluding imports from OPEC in order to leave aside oil imports as much as possible.) Europe has thus increasingly imported more from China, but less from the other Asian sources (almost 5 percentage points less from Japan) and from the US. In short, China has become the hub of a massive reshaping of Asian production and trade flows – one third of Chinese imports are used as inputs for China’s exports to the EU [Dean, Fung and Wang 2007].¹²



¹² In its note on “China in international trade” (website 11 June 2007) the European Commission provided a similar graph and made the appropriate observations (“most of the products exported from China are assembled from parts made somewhere else, in Asia, Europe or the US [...]. China is replacing other Asian suppliers of developed countries”) without drawing the logical conclusion for designing the EU trade policy – that is, that there is no pint to discuss China’s trade deficit (from a trade perspective).

The contrast between this reshuffling of EU imports from Asia and the EU anxiety about imports from China raises questions about the current EU stance. Why does the EU complain so much about China’s increasing import share, while ignoring the increased imports from the rest of the world, and keeping a blind eye on the decreasing import share from the EU other major Asian trading partners? In other words, who is Europe defending? Is it its own industries, or is it the Asian and US industries which are reshaped by China’s emergence?

Graph 3 compares the cumulated shares (in total EU exports) of the EU exports to the set of the same ten countries and for the same years. The destination with the largest increase of the EU export share is China – the annual compounded growth rate of EU exports to China is 14 percent (not so much smaller than the 19 percent rate for EU imports from China). In other words, the current ‘low’ share of EU exports to China in total EU exports mirrors largely the fact that, in 1995, this share was already half the share of the EU imports from China in total EU imports (2.8 compared to 5.2 percent). Indeed, Europe is China’s fastest growing source of imports. Why then are there so many tense EU complaints on the ‘limited’ growth of EU exports to China, combined with such a silence on worse EU performances in the world other export markets?¹³



¹³ According to a study commissioned by the European Commission, the loss of exports due to the Chinese trade barriers is estimated to be up to Euro 20 billions [Emerging Markets Group 2007]. Even leaving aside the methodology used by the study, such an approach is unconvincing if only because it provides no estimate of the EU exports that would be diverted from other markets to the more open Chinese markets (hence it gives no indication of the net effect).

Meanwhile, during the last decade, the EU global (vis-à-vis the world) trade deficit has remained modest. Even the EU 2006 trade deficit represents a GDP share smaller than those reached in 10 out of the last 44 years (and it is definitively not in the same league than the astronomical US trade deficit).

In short, the major difference between today and the 1980s or 1990s is that the EU global trade deficit is not spread over several Asian countries, but that it is largely concentrated on one of them – China. This concentration does not justify the current aggressive stance of the EU trade policy in goods towards China (even though, as seen in section 3, this concentration may shape some concerns in the behind-the-border agenda).

Trade and exchange rate: an economic and political trap for Europe

Until mid-October 2007, EU officials had refrained, though with increasing difficulties, from talking about the need of ‘realignment’ of yuan exchange rate (that is, re-evaluation) as a way to reduce the EU trade deficit. This silence has been breached by the EU Commissioner for Economic Affairs at the October G7 Finance Ministers meeting, although the EU is still far (but for how long?) from the approach frequently adopted in the US, which considers the ‘yuan fundamental misalignment’ as an undisputed fact and considers China as a ‘currency manipulator’.¹⁴

Strong and mutual reinforcing economic and political reasons should induce EU officials not to enter the murky water for two main reasons – and to come back to their initial position for a host of reasons.

¹⁴ Half-a-dozen bills imposing retaliatory measures have been tabled in the US Congress. To be fair, most of these proposals have few chances to be adopted by the Congress and the President, or are not WTO-compatible. One of the most famous of these bills is the Graham-Schumer Bill which was strongly opposed by the Bush administration and many business groups. The Bill threatened to impose a 27.5 percent tariff on China's exports to the US unless China significantly raises the value of its currency within six months. It relied on a widespread US view that China's currency is undervalued by 15 to 40 percent. The Senate voted 67-33 in favour of the Graham-Schumer Bill when it was offered as an amendment to another bill. In exchange for dropping the issue at the time, the two senators were promised another vote on their legislation at a later date. That vote had been delayed several times, but the Bill was withdrawn two days before the final vote. The Bill was said unlikely to pass the House of Representatives and to become law, but the opponents to the Bill worried that Senate approval alone would worsen trade relations with China.**

First, from a purely economic perspective, to predict the “right” exchange rate is an impossible mission. Economists disagree hugely on the level of the yuan under evaluation – from zero to nearly 50 percent, largely for reasons related to assumptions, variables included, etc., as it has been carefully shown by two recent IMF studies [Dunaway and Li 2005, Dunaway, Leigh and Li 2006]. A recent study suggests that, if there is an undervalued currency (against the dollar) in Asia, it would be the Japanese yen [Morgan Stanley, quoted by The Economist, June 21, 2007]. The same study suggests that the euro would be ‘over-valued’ against the dollar by 5 to 35 percent. (All these estimates have been calculated before the recent decline of the dollar.) The inability to predict the ‘right’ exchange rate of a currency (particularly in a fast changing world like today world, and especially China) is one of the strongest arguments for justifying the recourse to market mechanism for determining the exchange rates.¹⁵

Second, in addition to this fundamental economic reason, there is a strong political reason for EU officials to refrain from talking about currency changes. A few key euro-zone members (France, Italy) do not share yet the long and well-respected tradition of the other members to let their economy adjusting to market-driven exchange rates. As a result, exchange rates will remain a deeply internally divisive issue in the eurozone countries for some time. Better not to wake up too much the beast.

Lastly, the yuan exchange rate is unlikely to be the only – even the main – channel of corrections required by the existing trade imbalance. Moreover, in the interest of all the countries, and particularly of the EU, the US and China, these corrections should be as smooth as possible. Hence it should require more changes than mere exchange rate adjustments. Deeper macroeconomic changes are needed, particularly an increase in the US saving rate and in the Chinese spending rate [Deutsche Bank Research 2007] and deep structural reforms in Europe. The EU and the US do not seem ready to undertake policies that all these changes required. That said, in the absence of these deeper macroeconomic and structural changes, the massive accumulation of Chinese foreign currency reserves has

¹⁵ China cut tax rebates on 2,831 types of products from July 1, 2007, and the government is studying further measures to narrow the gap. Export taxes and import subsidies are imperfect substitutes to a market-driven currency re-alignment. But they tend to be costly because they are discriminatory. As they favor some products at the detriment of others, they create “artificial” winners who then try hard to keep the *statu quo*, opposing further adjustments of the economy. Moreover, being governmental decisions, they tend to trigger speculative shipments from traders.

important consequences for international investment – to the point to become a key component of the behind-the-border agenda of the EU trade policy towards China.

SECTION 3. LOOKING BEHIND THE BORDER

Up to now, the EU-China trade relations are still ruled by a treaty dating back from 1985. At this time, China was a planned economy starting its GATT (WTO did not exist) accession negotiations, and the trade policy of all the countries were confined to trade in goods.

A new China-EU trade agreement would thus be useful for the two parties, particularly for the many issues – often called the ‘behind-the-border’ agenda – that are now part and parcel of modern trade policies, such as investment, services or intellectual property rights, and that are not, or only imperfectly, covered by the WTO negotiations. This is the context where, in September 2006, the EU and China have agreed to launch negotiations on a “Partnership and Cooperation Agreement” (PCA).

In the PCA perspective, the EU is pledging to keep its markets open to Chinese exports of goods in order to support China’s export-led growth. But, in return, the EU is requesting of China a better intellectual property rights enforcement, more open services, lower restrictions on EU investments, non-tariff barriers and subsidies, more open government procurement, improved norms and standards, a better legal enforcement, etc.

The section argues that the EU list of requests is too long and broad to be an useful guide for the PCA negotiations. Such a length and scope could be explained by the tactic of piling up topics with the hope that a final trade-off will be easier to find if there are many topics on the table. But such a tactic has proven disappointing, as best illustrated by the unceremonious abandonment of the EU-sponsored “Singapore issues” (such as trade and competition) in the Doha negotiations. Moreover, it ignores an important difference between trade in goods and the behind-the-border agenda. In the former case, implementing liberalization is not costly – dismantling tariffs does not impose administrative costs, on the contrary, it reduces them. By contrast, services or investment liberalization may require new regulations increasing implementation costs. In short, negotiating on the behind-the-border agenda cannot be limited to a “give-and-take” approach (as for tariffs) but it requires a thorough assessment of the related costs, in order to pick up the options which would minimize these costs.

The question is thus which topic(s) Europe should prioritize. What follows argues that, from an economic perspective, the EU should concentrate on the investment and services issue, and that it should have much more focused requests in the other issues. Interestingly, political considerations reinforce the economic view. For instance, it will be much easier for the EU to find Chinese interests (consumers and/or workers) supporting a strong EU stance on services or investment than Chinese interests supporting a strong stance on intellectual property rights in audiovisuals.

Intellectual property rights

Despite much improved laws, China's enforcement of intellectual property rights (IPRs) is still chaotic. That said, it is hard to realistically expect a quick fix of these matters in a continent-wide, very fragmented economy (see the above section on the "Three Chinas"). However, short term realism should not be the main reason for a change in the EU current position. More fundamentally, the EU position on the IPRs issue with China should be driven by long term considerations that are missing in today EU approach. Such considerations suggest a much more restrained EU negotiating agenda on IPRs.

Back to basics

Most IPRs (such as patents or copyrights) are transitory monopolies granted by governments – on behalf of the current and future consumers – as a price to pay for promoting innovation. They should not be transitory monopolies granted “for free”, that is, generating no or tiny additional innovations all the more because there are other, competitive, ways to support innovation. As a result, the delicate balance between the degree of monopoly and the innovation intensity is in constant flux, even in the industrial economies. For instance, the debates on generic drugs, on the true value of some patented drugs¹⁶ or on audiovisual rights [Lévy and Tornile 2006] are raging in many EU Member States. And, some EU firms have taken initiatives self-limiting their IPRs, as best illustrated by the Sanofi-Aventis commitment to sell a new malaria drug (developed in collaboration with the DNDi foundation) at cost [Sanofi-Aventis 2005].

¹⁶ In some European countries, Social Security authorities have begun to publish lists of drugs with “no notable” effects, and to delete these drugs from the lists of drugs benefiting from reimbursement.

In fact, many EU firms do operate in China under “reduced” (compared to those prevailing in their OECD markets) IPRs. Interestingly, a recent study exploring China’s IPRs environment [Emerging Market Groups, Study12 2007] quotes EU firms suggesting that they do not bother so much about this situation (some firms declare that they do not even bother to register patents in China). EU firms provide a wide variety of reasons explaining such a remarkable moderation, ranging from the expiration of the IPRs in their EU country of origin to the candid recognition that “there is nothing secret” in their IPRs [Emerging Market Groups, Study12 2007, page 19, Box 1]. Of course, EU firms may not have mentioned the other factors that could explain such moderation, namely arm-twisting relations with Chinese partner firms or fears of retaliation by Chinese authorities.

But, the bottom line is that, ultimately, the EU firms do operate in China because they value the expected monopolistic rents from their IPRs less than the expected benefits from operating in the *de facto* (if not *de jure*) more competitive but large Chinese markets. Would not have they been led to this conclusion, they would not have entered the Chinese markets.

In short, there are robust economic arguments suggesting that, from a public as well as from a private perspective, the EU IPRs-related trade policy should focus only on those cases where the net benefits from IPRs are crystal clear – leaving the others to the tribunals. This limited approach is justified all the more by the fact that the IPRs balance of monopoly and innovation, of public action and market forces is not the same for countries with wide differences in terms of income and technology (the wide differences among the Chinese provinces noted above exacerbate further such a problem¹⁷).

Political considerations reinforce the need for EU restraint in IPRs-related trade negotiations. Such negotiations are much more conflictual than those on tariffs for a good reason. When the EU requests China to lower a product tariff, it looks as a foe of the Chinese producers (entrepreneurs and workers) of this good, but as a friend of the Chinese consumers of this product – be the Chinese firms using this product as an input in their production, or be the

¹⁷ Indeed, the wide income differences in China give an interesting twist to the IPR debate. In the mentioned study [Emerging Market Groups, Study 12, 2007] several EU firms clearly do not consider as an “intellectual property right” the fact of simplifying a product and selling it at a much lower price than the initial European machine. In a strict sense, one could conceive patents on “simplified” products which could be exported to poorer Chinese regions, and possibly to the rest of the world, including the OECD countries.

Chinese households. In sharp contrast, when the EU fights for a strict IPRs regime in China, it looks as a foe of both the Chinese producers and consumers of the product(s) in question because not only a strict Chinese IPRs regime would tend to exclude Chinese producers from entering the market(s) in question, but because it would also raise the price(s) to be paid by the Chinese consumers. AN EU fight for IPRs would get popular support in China only when Chinese consumers would recognize the value of patents – such for serious drugs.

Looking in the long run perspective reinforce even more a plea for EU restraint in IPRs negotiations. Looking backward, the history of the relations between Europe and China is a long history of innovations with little consideration for Chinese IPRs by the European side (think about silk production) – not especially an history making popular negotiations on a strict IPRs regime today. Looking forward, a EU strong fight for strict IPRs in China may be costly for the EU producers and consumers in the long run – when China will be the largest source of new IPRs in the world (it is largely a matter of time). Better for Europe (and the other industrial countries) to have reached before then the economically soundest balance between monopoly and innovation in IPRs regulations.

To conclude, the opportunity costs of negotiations on IPRs for the EU should be measured by the number and the importance of the other topics to be abandoned for achieving success on the IPRs front. For economic and political reasons, these costs are likely to be very high. For instance, a strong EU fight for the elimination of China's production of pirated DVDs is surely crucial for the revenues of two or three dozens of key EU (and non-EU) film actors and producers. But, focusing on such an issue in the PCA context could be achieved only at the cost of giving up other – more profitable for the EU – aspects of the PCA, be IPRs in essential drugs or crucial services and investments.

Re-assessing EU own interests in IPRs: the “geographical indications” case

It is even far to be certain that negotiating on strong IPR regimes is in the EU own interests. The best illustration of such doubts is a specific kind of IPRs called “geographical indications” (GIs). Article 22.2 of the Uruguay TRIPs Agreement requires Members to provide the legal means (that is, GIs) to prevent the use of any means “*in the designation or presentation of a good that indicates or suggests that the good in question originates in a geographical area other than the true place of origin in a manner that misleads the public as*

to the geographical origin of the good,” as well as any use “*which constitutes an act of unfair competition*”. In contrast with patents, GIs do not aim at promoting innovations, but at giving information on “reputation”. But, as patents, GIs limit competition by imposing a “register” listing the conditions necessary for benefiting from the desired GI labels (from champagne to gruyère). The stricter the mandatory conditions imposed by the register are, the stronger the implicit degree of monopoly created by the register is.

A topic may be part of ongoing negotiations simply because it was part of previous negotiations – inertia happens in trade negotiations. The EU interest in GIs dates back from the Uruguay Round. It was driven by the will to compensate EU farmers for liberalization in agriculture – an awkward justification because GIs involve more the food processing firms than the farmers *per se*.

Even stranger, during the last decade, the French wine sector has given ample proof that a strong GIs regime can be seriously damaging. Under the French strong GIs regime for wines, some French wine yards have performed well, but others very poorly – suggesting that “something else” than GIs is key for success in the modern wine business. Evidence from the last decade suggests that GIs alone can have serious perverse effects (freezing the production technology, generating cheating behavior leading to overproduction, disappointing consumers, etc.). And, it suggests that what counts is the existence of large wine companies (such as in Champagne) capable of meeting an ever changing demand while delivering the required level of quality and reputation via trademarks.

The wine case should induce the EU to review seriously its insistence to include a strong GIs regime in the PCA – and in the Doha Round. It may be argued that such a topic is a critical part of the EU balance of internal interests, and that it would be too costly to abandon it from an EU internal negotiating balance (although one wonders whether a few cheese and ham producers may have such a power). But, as always, such an argument relies on its opportunity costs, that is, on the other offensive interests (other IPRs, services, investment, etc.) that the EU would have to give up in order to get China acquiescing on adopting and enforcing a strong GIs regime. Clearly, the net balance including these opportunity costs is largely negative.

Services liberalization

In sharp contrast with IPRs, European requests for more open services in China should attract support from Chinese consumers. However, though economically sounder and diplomatically much easier than the IPRs case, further services liberalization in China faces three difficulties.

First, services liberalization is technically notoriously difficult, as best illustrated by the ups and downs of the EU Services Directive and the still very fragmented European Single Market in services. Second, the fact that China is the WTO Member with the deepest services liberalization in the WTO context [Mattoo 2003] does not induce China to take bold initiatives in this domain.

Last but not least, trade negotiations are not yet driven by the same dynamics in China than in the EU or in many other countries. Since the launch, in 1978, by the Chinese government, of the ‘reform and openness’ policy as a pattern of social and economic development, the Chinese economy has become much more market-oriented. But, the Chinese firms are still far to develop the same level of efforts than the EU firms for making their case to the trade authorities. Chinese public opinion rarely shows its interest in trade matters. As a result, the Chinese trade authorities still enjoy a degree of autonomy of decision in trade issues that the authorities of China’s partners have lost since a long time. This difference explains, for a large part, the lack of reactivity in China on trade issues – hence the difficulty for its trading partners to recognize and ‘mobilize’ Chinese allies (contrary to what happens routinely in the EU and many other countries).

The EU should thus find attractive concessions to offer to China if it wants more open Chinese services. Paying the opening of China’s services markets by offering to open EU services markets may not be such an attractive option to China because, at this stage, few Chinese services providers may benefit from such an opening.¹⁸

An alternative would be to offer an earlier but progressive dismantlement of Section 16 of China’s Accession Protocol which establishes a “transitional product-specific safeguard” (TPS) mechanism [Messerlin 2004]. In a nutshell, the TPS makes legally very easy for a

¹⁸ Once again, one should be cautious on such statements. As shown in section 1, China has already developed provincial economies that could be quickly, if it is not yet the case, able to support sophisticated services exporters, as illustrated by emerging retailing services in the textile and clothing sectors.**

WTO Member to impose safeguard measures against Chinese exports until 2014. Moreover, as soon as one WTO Member takes a TPS measure against Chinese exports, the others WTO Members could enforce a similar measure at almost no cost in terms of legal procedures. In short, keeping untouched Section 16 while getting the market-economy status in antidumping procedures may well be a Pyrrhic victory for China.

The EU may thus offer not to use the TSP for the goods (or sectors) which would meet certain conditions to be agreed with China in the PCA negotiations. Such conditions could be low Chinese tariffs (say less than 10 percent) on the goods to be exempted from the TSP in order to ensure that the Chinese markets of the products or sectors in question are well disciplined by world markets. Another condition could be the elimination (or clarification) of a well-defined core set of China's "non-tariff barriers", such as some norms and standards, or their enforcement (or lack of).

A last condition for not using the TSP could be the opening of the services sectors associated to the products to be exempted from the TSP use. For instance, this condition would mean the elimination of the distribution monopolies (be state-owned or private) distributing in China competing foreign and Chinese varieties of the products in question.¹⁹

International investment

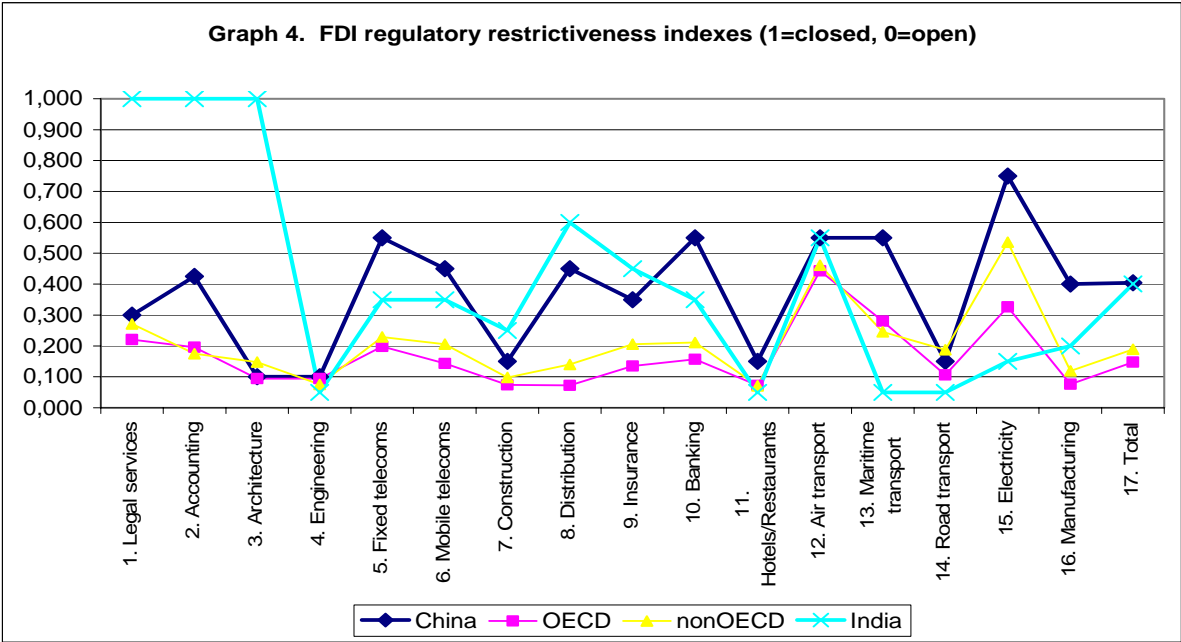
An EU focus on international investment (hereafter, foreign direct investment or FDI) seems appropriate because it is closely related to services liberalization. Negotiations on FDI have another – political – advantage: Because China faces inward and outward FDI, negotiations offer opportunities of mutually beneficial concessions.

China's inward FDI

Investment regulations are the Achilles' heel of China's liberalization. China is one of the most attractive countries for FDI, but its restrictions on inward FDI are among the highest in the world, as illustrated by Graph 3 [Koyama and Golub 2006]. They are as high as those in

¹⁹ Paradoxically, Chinese state-owned sole *producers* are much more acceptable because, as shown by economic analysis, a protection granted exclusively by a moderate tariff to such firms eliminates the risk of monopoly power of the domestic sole producer.

India, and much higher than those imposed by the other non-OECD countries included in the OECD study (Argentina, Brazil, Chile, Israel, Russia and South Africa).



Inward FDI in services is a particularly attractive topic of negotiations from both EU and China sides because it is a large net creator of domestic jobs in the host country. This is particularly true in China where it is hardly conceivable to operate services on a large scale without Mandarin-speaking workers. In other words, not only Chinese consumers but also Chinese workers may actively support lower restrictions on inward FDI in Chinese services.

Such FDI may even be attractive to the Chinese authorities for two reasons. First, competition in services is much more based on differentiation (services are almost endlessly differentiable) than competition in goods. As a result, Chinese firms can face much more easily the competitive pressures of foreign firms in services than in manufacturing. Second, more varieties in services are likely to stimulate and deepen domestic Chinese consumption, whereas inward FDI in goods mostly stimulates Chinese production for exports.

That said, the EU has the choice between two alternative strategies when requesting more open Chinese services markets. Either, Europe targets the Chinese services sectors in which the EU firms feel to have comparative advantages (as it did in the China’s pre-WTO accession negotiations). Or, Europe could choose to negotiate an opening of the FDI conditions as uniform (non-discriminatory) as possible among all the Chinese services sectors. By

definition, this option would *de facto* target China's currently most protected sectors (electricity, banking, telecommunications, air and sea transport according to Graph 3).

From the economic point of view, the second option is definitively the best from China's perspective because, in services as in goods, the highest restrictions are the most welfare-deteriorating for the Chinese consumers. It is also an attractive option for the EU because services are still so much distorted by all kinds of protection in all the economies in the world that services providers have hard time to get a correct assessment of their comparative advantages [Langhammer 2006].

That said, it may be difficult for China to liberalize all of the mentioned sectors. As an alternative, the EU could request the reduction of the largest differences between China's and OECD's FDI restrictiveness indexes. Electricity, banking and fixed telecommunications would then become the core of the negotiations. In particular, more openness in banking and fixed telecommunications will be profitable for Chinese consumers and producers of goods and other services. Another alternative could be for the EU to request the reduction of the largest differences between China's restrictiveness indexes in services and in manufacturing. This option would open one more service (maritime transport) but it would have the great advantage to make more uniform the investment barriers in manufacturing and services – hence diverting such investments away from manufacturing towards such services.

China's Outward FDI

Outward FDI is a mirror image of the crucial macroeconomic imbalances evoked in section 2 (high Chinese saving rate and US consumption rate). Massive inward FDI in China's industrial sector creates China's massive labor-intensive industrial exports which, combined with a very high Chinese domestic saving rate, generate massive reserves of foreign currencies. Until recently, China's reserves were largely invested in liquid assets (US Treasury bonds). Today, roughly 70 percent of these reserves (managed by the State Administration of Foreign Exchange under the supervision of the People's Bank of China) are believed to be held in US dollars, the rest being invested in higher-yielding assets [Financial Times, January 21, 2007].

These successive evolutions boosted Chinese outward FDI which amounted to US\$ 2.9 billions in 2002 and in 2003, 5.5 billions in 2004, 12.2 billions in 2005, and 16.1 billions in 2006. Table 3 lists the most important acquisitions by Chinese firms until January 2006.

Table 3. Major outward acquisitions by Chinese companies (January 1999 to January 2006)

Announcement date	Deal status	Acquired stake	Bid value (Euro m)	Target name	Target domicile	Chinese bidder	
						Name	Legal status [a]
2001,06	Completed	100%	1154	Hyundai Display Technology	Korea	BOE Technology	private
2002,01	Completed	86%	672	Repsol-YPF (Indonesian assets)	Indonesia	CNOOC	SOE
2003,11	Completed	67%	450	Thomson SA (TV unit)	France	TCL	private
2004,07	Completed	49%	419	Sangyong Motor	Korea	Nanjing Auto	SOE
2004,12	Completed	100%	1303	IBM (PC unit)	USA	Lenovo	private
2005,07	Completed	100%	72	MG Rover	Britain	Nanjing Auto	SOE
2005,08	Completed	100%	3204	PetroKazakhstan	Canada	PetroChina	SOE
2003,10	Pending [b]	13%	593	Gorgon Liquefied Natural Gas Field	Australia	CNOOC	SOE
2005,06	Pending [b]	100%	370	PetroChina International	Indonesia	CNPC, PetroChina	SOE
2006,01	Pending [b]	45%	1894	Akpo oil filed assets	Nigeria	CNOOC	SOE
2005,05	Aborted	n.a. (100%)	15255	Unocal	USA	CNOOC	SOE
2005,06	Aborted	n.a. (100%)	1050	Maytag	USA	Hai'er	private

Source: Deutsche Bank Research 2006

Notes: [a] SOE: state-owned enterprise. [b] As of January 2006.

Since then, two operations deserve to be noted because they have attracted a lot of attention in China and in the EU. In May 2007, China's new state investment agency acquired a US\$ 3 billion stake (8 percent of the capital, with no voting rights) in the Blackstone Group, one of the largest private equity investment firm, and among the last ones to set up shop in China. In July 2007, Barclays Bank announced that China Development Bank (and Temasek from Singapore) would be ready to invest in Barclays Bank, making feasible the Barclays' bid on ABN Amro (this attempt failed after the subprime crisis of early Fall).

The analysis of China's outward FDI would be incomplete without examining the ways these investments are made – that is the role of the so-called 'sovereign wealth funds' (SWFs). In 2003, the Chinese authorities launched the "Go abroad" policy, and the China's State Council began to allocate a share of foreign exchange reserves to outward FDI. The same year, the State-Owned Assets Supervision and Administration Commission (SASAC) was created. Initially, the largest 161 state-owned enterprises (SOEs) were affiliated to SASAC, and most of these SOEs are enjoying preferential finance and insurance support from institutions such as China's Bank of Development. In 2003 and 2007, China established its own SWFs. As shown by Table 2, once merged, the two Chinese SWF will make China's SWF one of the largest in the world, with roughly US\$ 300 billions in assets.

Table 4. The largest Sovereign Wealth Funds, 2007

Country	Fund	AuM US\$ billion	Inception	Origin
U. Arab Emirates	AbuDhabi Investment Authority	875	1976	oil
Singapore	Gvt of Singapore Investment Corporation (GIC)	330	1981	non-commodity
Norway	Government Pension Fund of Norway	322	1990	oil
Saudi Arabia	(various funds, na)	300	(na)	oil
Kuwait	Kuwait Investment Authority	250	1953	oil
China	China Investment Company Ltd	200	2007	non-commodity
Hong Kong	Hong Kong Monetary Investment Portfolio	140	1998	non-commodity
Russia	Stabilization Fund of the Russian Federation	127	2003	oil
Singapore	Temasek Holdings	108	1974	non-commodity
China	Central Hujjin Investment Corporation [a]	100	2003	non-commodity
Australia	Australian Government Future Fund	50	2004	non-commodity
Libya	Reserve Fund	50	(na)	oil
Qatar	Qatar Investment Authority	40	2000	oil
US-Alaska	Alaska Permanent Reserve Fund Corporation	40	1976	oil
Brunei	Brunei Investment Agency	30	1983	oil
Ireland	National Pensions Reserve Fund	29	2001	non-commodity
Algeria	Reserve Fund	25	(na)	oil
Korea	Korea Investment Corporation	20	2005	non-commodity
Malaysia	Khazanah National	18	1993	non-commodity
Kazakhstan	Kazakhstan National Fund	18	2000	oil
Canada-Alberta	Alberta Heritage Fund	17	1976	oil
Taiwan	National Stabilisation Fund	15	2000	non-commodity
US-Mexico	New Mexico State Investment Office Trust Funds	15	1958	non-commodity
Iran	Foreign Exchange Reserve Fund	15	1999	oil
Nigerai	Excess Crude Account	11	2004	oil
New Zealand	New Zealand Superannuation Fund	10	2003	non-commodity

Source: Deutsche Bank Research, September 10, 2007.

Note: [a] This SWF should be merged with China's other SWF.

Such acquisitions raise more complex issues than acquisitions by private firms (the fact that Russia tries to follow the same strategy than China amplifies these problems). They should raise no concerns as long as they obey the same incentives than private firms: upgrading products or technologies, ensuring access to essential natural resources for the firms, tariff-jumping (particularly in goods subject to repeated antidumping or safeguard measures, such as textiles, cycles or TV sets) generating assets for the future (a key goal of the oil-based or natural resource-based SWFs), etc. Indeed, few concerns have been heard for the many SWFs listed in Table 4 (including the largest).

But, their public ownership precisely questions their capacity to behave always as private firms. More precisely, it raises two problems. The problem the most frequently mentioned concerns the countries hosting the assets targeted. SWFs and SOEs go against two decades of privatizations in the market economies. These privatizations have often been hard to decide – it was not easy to convince people that privatization in a market-driven context was more likely to ensure a more efficient allocation of the resources in the long run than public enterprises. Privatizations were also hard to make successful – often they have kept enough remnants of the anti-competitive features of the former public enterprises to continue to operate under quite imperfectly competitive conditions (in short, private quasi-monopolies were replacing public monopolies, bringing no clear gains to consumers and no benefits to the

workers of the former public firms). The ongoing acquisitions by SWFs and SOEs endanger these slow and long efforts, with the additional concern that such reversals represent a ‘re-nationalization’ under the influence of foreign governments (with a lot of influence, in the case of China or Russia).

SOEs (and SWFs to the extent that they are dominated by SOEs) raise a second problem that is much less discussed because it concerns the SOE home countries. SOEs are plagued with many distortions – subsidies, public capital, managed prices, unaccountable management, non-transparent decisions, political influence, etc. Indeed, the problems that Chinese SOEs will raise from a Chinese perspective can be easily predicted by looking at their close cousins – the EU SOEs. EU SOEs have a long track record of costly and unsustainable foreign investments (France Telecom, Crédit Lyonnais, Vivendi, Westdeutsche Landesbank, Landesbank Sachsen, etc.) combined with relative disinvestments in domestic markets (Electricité de France). In sum, the costs for the Chinese tax-payers of the SWFs and SOEs are likely to be huge.

This domestic aspect of the problems raised by the SWFs and SOEs is crucial because it reveals that both China and its partners have strong interests in finding a satisfactory solution to the SWFs and SOEs question. In other words, the “unilateral” solutions put in great haste by China’s trading partners are, almost by nature, not optimal. In 2007, the US adopted a law enhancing government scrutiny of proposed sales of critical infrastructure businesses to foreign government-controlled entities via the creation of the so-called Committee on Foreign Investment in the United States (CFIUS). Similar laws have been passed in France, are in the process to be passed in Germany and other EU Member States, and in Canada (a similar law is also envisaged by China). All these laws include, almost inevitably, some language loose enough to open the possibility of wide interpretations and discriminatory decisions – in short, they may be a back door to protection of domestic assets against foreign capital.

A better solution requires a multi-dimensional policy. First, China and its partners should work on their own domestic markets. For China, privatizing the SOEs is a key part of the solution. For the EU, deepening the Single Market is also part of the solution: the larger the European markets will be (meaning the “Singler” the Single Market will be) the more competitive the European markets will be, the lower the risks of distortions generated by

SWFs and SOEs will be. Of course, the problem is that clearly these two goals – in China and in the EU – require time to be achieved.

What can be done in the short term? A solution consists to subject the SWFs and SOEs to high transparency standards. However, except the Norway's SWF, SWFs are not known as paragons of transparency. As a result, the PCA negotiations between China and the EU could then examine whether it would be possible to establish joint bilateral procedures for the cases raising concerns. In order to reduce the risks of conflicts, these procedures could involve neutral, knowledgeable and trusted by both sides international institutions (such as, the Bank of International Settlements).

Subsidies, Government Procurement, Norms and Standards

The EU list of important topics under the behind-the-border agenda also includes subsidies, government procurement, and norms and standards. It seems unlikely that the PCA negotiations could not go very far for the two first items for two reasons. Subsidies is a topic that cannot be handled meaningfully in a bilateral context – by nature, they imply a multilateral framework of negotiations (one cannot subsidize with respect to some markets, and not with respect to other markets). Public procurement is not a promising topic if only because the role of the “sub-central” authorities (provinces, Member States, towns, etc.) is often more important than the role of the ‘central’ authorities.

Norms and standards are a different matter. Such issues are likely to be the bread and butter of the EU-China negotiators for a long time to come. This should not surprise the Europeans since these issues are still the source of differences and conflicts within the EU. That said, the EU should adopt a nuanced stance in this domain – if only because it is hard to complain on Chinese norms when the world is still waiting for the scientific evidence of the decade-old EU bans of beef hormones or GMOs.

The last months have witnessed an unpleasant turn in the norms and standards domain. Unsafe Chinese exports (particularly, in toys) have been rapidly pilloried (to be fair, mostly in the US). That has been done with no comparable tests on competing EU (or US) production, nor on the corresponding imported products imported from other countries than China. The EU should make clear that tests showing unsafe Chinese products should be immediately

imposed on the competing EU products or imports from other countries than China. This rule would eliminate the risk of norms and standards being used as a protectionist device, while not modifying the existing norms. It will reinforce the EU position with respect to China in these complex issues – and, indirectly, the position of the Chinese government with respect to its own exporters.

SECTION 4. FROM TRADE TO FOREIGN POLICY

As underlined in the introduction, the EU trade policy is an integral part of Europe's foreign policy. In the China-EU case, these emerging interactions between trade and foreign policies are most visible in Africa and in Asia.

Africa and developing countries

Africa has always been a clear illustration of the EU trade policy as foreign policy. The economic decline of many African countries since the 1970s has made less visible this aspect, but China's rapid emergence in Africa has restored it. In November 2006, China made clear its strategic views on Africa by hosting the first China-Africa forum (including in French!) echoing the growing trade and investments by Chinese firms in Africa and the opening of China's huge and booming cotton market to African exports. Africa (most notably, Angola, Sudan and Congo) is particularly rich in the raw materials (from oil to wood to cotton) needed by China's industries – making China a supporter of an immediate duty-free, quota-free treatment to products from the least developed countries [Wang 2007].

The first years of the Doha Round have witnessed China opposing the EU proposal of a 'Round for free' for the least developed countries (LDCs, many of them being in Africa). Pascal Lamy, then Trade Commissioner, tabled this notion largely for buying LDCs' support for EU positions. From an economic point of view, a Round for free is costly for the LDCs which, more than any other country, need to open their markets – admittedly in a careful way – in order to grab all the gains they can from freer trade. But, from a political point of view, a Round for free was pleasing African countries reluctant to liberalize. Its initial opposition to a "Round for free" put China in an uncomfortable position in the WTO. While China was providing the economically sound support to the long term reforms so much needed for accelerating LDCs growth, it was confronting the LDCs officials who like the diplomatically

and domestically comfortable inertia offered by the Round for free proposal. Ultimately, China came back to the usual rhetoric of the developing countries when leading the so-called 'G33'. This coalition of WTO Members aim to limit, as strongly as possible, market access from developing countries through the notions of 'special' products and a 'special safeguard mechanism'.

When redesigning its trade policy vis-a-vis the African-Caribbean-Pacific (ACP) countries, the EU should make these countries less dependent from bilateral influences [Delpeuch 2007] be vis-à-vis Europe or China.

Asia and preferential trade agreements

The second – much more important for the future – illustration of trade policy as a foreign policy is given by the preferential bilateral trade agreements (hereafter, 'bilaterals'). In November 2006, the Commission tabled a working document suggesting negotiating a large number of bilaterals (24 including China). This is a profound change of course in European trade strategy – away from multilateralism and towards bilateralism. By contrast, a trade policy based on bilateral agreements has a familiar face to China's diplomacy – indeed, it echoes the Chinese imperial tradition dating back from the Tang to early Ming dynasties where trade agreements were instrumental for the recognition of the political supremacy of Chinese Emperors.

From an economic perspective, these initiatives are embarking the EU (and indeed China) into dangerous waters. In sharp contrast with the bilaterals under negotiation or consideration by five other countries (Chile, Japan, Korea, Singapore and the US) the bilaterals envisaged by the EU (and China) are characterized by high tariffs and/or non-tariff barriers in goods, and by restrictive regulations in services and investment [Messerlin 2007]. Economic analysis shows that such conditions are likely to generate strong distortions in trade and investment flows, at the detriment of the European (Chinese) consumers in the short run, and of the European (Chinese) producers in the long term. In other words, the EU- (China-) sponsored bilaterals that are starting with smiles will end up in cries.

From a political perspective, a bilateral-based policy appears a major strategic mistake for the EU for three reasons. First, one may wonder how the EU trade diplomats will be able to

extract more concessions from China in a *tête à tête*, when they have been unable to do so in the WTO multilateral forum during the Doha negotiations.

Second, a bilateral-based policy will almost inevitably generate severe intra-EU tensions. Opening negotiations for new bilaterals is almost certain to re-open the delicate internal EU balance of interests that was needed for building the consensus required for concluding the previous bilateral(s). For instance, a bilateral with (say) Korea may open the Korean insurance market to (say) one EU insurer. But, this EU insurer that may have preferred a preferential market access to Indonesia will not be happy when an EU competitor will be chosen for entering the Indonesian insurance market, once the EU will have concluded a bilateral with Indonesia.

Last but not least, the EU focus on bilaterals is likely to amplify incentives among Asian countries to negotiate bilaterals between themselves, risking by the same token to marginalize further the EU. One could argue that Asian countries may not need such an additional incentive, and that they may be heading to an Asian Economic Area anyway, as Europe did fifty years ago. However, any parallel between Europe and Asia underestimates two critical factors behind the European endeavor. First, the trade between the EU founding Member States before the EU creation was different – in nature and depth – from the current trade between the Asian countries [Kang 2007]. Second, the Asian countries do not enjoy the very special political situation that has characterized the EU endeavor since its inception, namely the fact that the EU large Member States have always had roughly a similar economic size. In other words, there was no serious threat of supremacy of a large European Member State over the others. This is definitively not the case in Asia. Indeed, the huge asymmetry in terms of size among the Asian economies could only make most Asian countries happy to see the EU (and other non-Asian countries) keeping a multilateral approach to trade issues because it is their best guarantee of political independence.

CONCLUDING REMARKS

Until mid-October 2007, the EU policy towards China has had a friendly sound, with its emphasis on dialogue as the only efficient way for solving problems. However, its numerous and broad goals did raise some questions on the EU ultimate objective: was it to force the European firms to adapt to the Chinese markets, or to change China's economy and some

aspects of its society? Since mid-October 2007, the EU has adopted a more confrontational tone that raises even more questions. After summarizing what could be an EU trade policy towards China based on foresightedness, the conclusion discusses its implications in a truly global world before commenting the very recent EU approach.

Summarizing opportunities for the EU and China (and the world)

The paper argues that one can design an EU trade policy that promotes EU interests while attracting support from Chinese interests in four key domains:

- Concerning trade in goods, the EU could develop an initiative for a ‘joint better enforcement’ of the WTO Protocol Accession – the EU granting the market economy status in antidumping investigation to China, and getting from China’s clarification, confirmation and some improvements in its tariff schedule as back.
- Concerning the intellectual property rights (IPRs), the EU should narrow down its requests to the limited range of IPRs that deliver true innovations (for instance, quality drugs), and leave the other IPRs (from audiovisuals to geographical indications) to private initiatives and dispute settlement.
- By contrast, the EU should focus its requests on services and foreign investment. It could develop an initiative based on granting an early and progressive elimination of the special safeguard included in China’s WTO Accession Protocol in exchange for getting additional and clearer commitments from China in services and investment. The Chinese sovereign wealth funds and state-owned enterprises raise complex problems for both economies (several EU Member States know how costly are the unchecked international operations of state-owned enterprises for the owning country). As a result, such problems require cooperative actions.
- The EU should review its current initiative on bilaterals, and re-focus its trade policy on the WTO. China has an indirect interest in such a balancing for two reasons. First, progress in the WTO contributes to the emergence of a real ‘Chinese Single Market’, whereas bilaterals may favor a deeper segmentation of the Chinese provincial markets. Second, the WTO forum diffuses political conflicts that bilaterals tend to re-activate, sooner or later (see the EU-Turkey case, the EU potential troubles with Myanmar as member of the ASEAN or the US-Korea case, etc.).

All these initiatives will find support in the EU as well as in China – among firms or consumers – a feature that is not shared by the other options examined by the paper. That said, the paper argues that (perhaps surprisingly at a first glance) to improve function of its own domestic markets should also be an intrinsic part of the EU strategy towards China. For instance, the potential EU-China clashes in energy could be reduced if the physical interconnections of the EU domestic energy markets are improved, what allows to optimize the EU energy options.²⁰ Similarly, a deepening of the Single Market in services would partly alleviate the fears raised by China’s sovereign wealth funds and state-owned enterprises.

A truly global approach

Such an ambitious program has no chance to succeed if it does not fulfill two conditions. First, it should keep a clear economic focus. In the PCA exercise, the EU Commission has gone much beyond economic issues. For instance, the paper ‘Closer partners, growing responsibilities’ mentions the need “*to leverage the potential of a dynamic relationship with China based on our values*” (underlines added) and it tackles political issues (China’s transition towards a more open and plural society, human rights, etc.). It does not pay to load the PCA with such political goals, if only because the EU has not the means that such an approach requires being fully credible. It does not mean the Europeans should be silent on these issues. Rather, it means such goals are the task of the Europeans in wide range (governments and civil society), but not of the EU trade negotiators.

The second condition is that the EU should combine its actions with other players in the world. It would be foolish for Europe to believe that it could get easy support in China if it acts alone. Mimicking the US-China ‘*tête à tête*’ initiated by the current US Administration would be a frivolous exercise, if only because Europe has not the same broad political interests and ways of action as the US.

The main difficulty is to ensure that concerted actions – ‘cooperation’ – among China’s trading partners when dealing with China would not be perceived by China as an aggressive coalition. Avoiding such a difficulty would be easier if the cooperation involves a notable

²⁰ A substantial increase of the competitive nature of the EU energy markets may offer attractive alternatives to the current EU energy-saving programs that are burdened by a host of technical details which risk to further distort and weaken competition.

group of countries (possibly varying with the topics at stake). The US and Japan will be EU's systemic partners in such an endeavor, simply because their huge economies cover all the possible topics of negotiations. For instance, large-scale initiatives concerning Africa could not be launched without Japanese support, because the Japanese Exim Bank is the third largest export credit agency in Africa, with almost US\$ 9 billion, compared to China Exim Bank (almost US\$ 16 billion) the US Exim Bank (US\$ 14 billion) and the British Exim Bank (roughly US\$ 4 billion).

But, it would be essential for the EU to go beyond the US and Japan by ensuring the participation of medium-size countries in this cooperation exercise – from Australia to Korea to Chile, for instance. A key benefit of the presence of such medium-size countries flows from the fact that they are among the best ones in terms of domestic governance, they innovate faster and better in terms of regulatory reforms. In short, not only their experience would be more useful, but it would also be politically easier for importing by Chinese interests, which are eager to promote in their own country the best regulations that have been already tested in the rest of the world.

Comments on the EU more confrontational stance

The confrontational tone adopted by the EU since mid-October takes the opposite direction of the above suggestions. In our views, the emerging EU-US '*rapprochement*' is precisely what should be avoided, because it is useful neither for the EU, the US nor for China.

The focus on bilateral trade balance with China does not make economic sense, particularly from an EU perspective. The increasing bilateral share of EU imports from China in total EU imports is more than counterbalanced by the decreasing share of EU imports from the other Asian economies and from the US – these twin evolutions reflecting the huge reshuffling of production in Asia. Meanwhile, the share of EU exports to China may be seen as unsatisfactory by EU officials, but its growth rate (roughly 14 percent per year) is the highest one observed for the EU during the last decade, what suggests systemic problems in the EU. By being confrontational, the EU may miss the chance to keep open, or open more, the emerging huge (EU-like) Chinese markets of consumer goods produced in Europe.

The EU official support for rapid realignment of yuan takes serious economic risks. The Chinese economy is not immune to economic crises after the Olympic Games boom, with the domestic and international, economic and political, consequences are easy to imagine. The EU support is also politically counterproductive, because it makes more difficult the position of the Chinese supporters of such realignment in Beijing. It is a diplomatic gamble: as soon as the US would get the realignment of yuan it is looking for, why should it support the EU? The diverging evolutions of the dollar and the euro are such huge that the magnitude of the yuan realignment desired by the US is too small to solve the problems raised by the current appreciation of the euro for the euro zone economies. Such an appreciation imposes fast and deep structural adjustments of the euro zone economies – but, without much growth, it is extremely hard for reformers to do what they should do, as stressed by the French President.

As often at a critical period, it is worth looking at the past in order to find inspiration and support. Nobody could better suit this role than Cordell Hull. He provided the necessary foresightedness on trade issues by being the architect of the US open trade policy (and ultimately of the GATT with the notion of most favored nation) at a time when such a policy looked foolish. And, he was the US State Secretary who delivered the treaty abolishing the US extraterritorial rights in China, closing the doors of a century and opening another doors to a new century – our century.

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