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Back to Basics: Economic Reforms and EU-China Relations

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What will happen to trade relations between China and the European Union (EU) in the next few years?

China's rise to preeminence in world trade has been a source of economic growth for both China and Europe in the past decade. Today, the China-Europe trade relationship is "too big to fail". The EU is China's biggest trading partner, and China is the second biggest trading partner for the EU. It is also one of the most important bilateral trade relations in the world. Two-way trade is more than four times bigger today than in 2001 when China joined the World Trade Organisation (WTO). Bilateral trade recovered quickly from the sharp drop in 2008-9 amid the West's financial crisis and hit a record last year. Trade growth is now weighed down by falling demand in Europe, but total trade is still forecasted to edge close to 500 billion euro in 2012.

Both China and Europe have gained substantially from cross-border trade as their firms now can sell to more consumers. Recently, rising sales in China has been important for many European firms when sales in their domestic markets, and other export markets, have declined. Consumers in China and Europe have through trade gained access to products of lower prices and higher quality. Importantly for Europe, about two thirds of Europe's import from China is input goods, and this import has helped European firms to cut production costs and, consequently, made Europe's own export more competitive.

The trade relation between China and Europe is in many ways healthy. But it is also a trade relation that is increasingly subject to disputes and frustrations over protectionism. Neither China nor Europe is likely to allow actual trade to be fractured by profound and systemic economic and commercial policy conflicts. It is a sign of the maturity of China-Europe trade cooperation that current trade and investment glue the relation together. Yet for bilateral trade to flourish as much in the future as it has done in the past, China and Europe need to find new strategies to contain protectionist pressures and address legitimate concerns on both sides. For such strategies to be successful, however, they have to be backed up by economic reforms in China as well as in Europe.

Recent months have seen several examples of how China-EU trade increasingly gives rise to political friction. Europe, in particular, has been the source of defensive approaches to China-EU trade. New trade-defence cases in high-profile sectors like telecom equipment and solar panels have been launched. There are new talks about closing access to Europe's public procurement market for Chinese firms. And political leaders in Brussels have proposed that Chinese investments in Europe should undergo public security examinations – no doubt with the view of protecting some European sectors from the embrace of Chinese Foreign Direct Investments.

Such attitudes to commercial relations with China are deplorable. Yet one should not exaggerate their significance. Europe is frustrated about not getting better access to important markets in China – like the public procurement market. EU authorities are also pressured by domestic "sunset" industries – industries that cannot produce competitively in Europe anymore – that are bleeding money and request protection

from foreign competition. Still, trade defence action against Chinese exports covers only a tiny fraction of all Chinese exports to Europe. And many of the threats levied against China – e.g. if China does not open its market, Europe will close her markets to Chinese forms – are little more than empty threats.

But threats and defensiveness are reflections of a bigger problem – the absence of economic reforms in Europe to open markets and improve competitiveness. As was pointed out in China’s 12th Five Year Plan, and reiterated at the 18th Congress of the China Communist Party, this is a problem that China shares with Europe. Premier Wen noted a few years ago that China’s economic growth is “unsteady, unbalanced, uncoordinated and unsustainable”. China has a good potential to grow at high levels for another decade, but to achieve its potential there will have to be progressive economic reforms that make greater parts of its economy more conducive to market competition and market innovation. Markets have to be opened up, especially many behind-the-border regulations have to be eliminated, and regulatory policy has to become more compatible with modern value creation in international business.

Consequently, what is important for China-Europe relations in the future is that economic reforms on both sides are advanced. While it is important to design common strategies to contain defensive and protectionist responses, the best strategy to protect current exchange is to expand it and unleash its potential. Both Europe and China have powerful industries with protectionist preferences that cause frictions in the bilateral relation. It is difficult, if not impossible, to address these frictions by diplomatic actions in bilateral trade policy. However, both China and Europe could prevent such industries from weighing down potential bilateral trade expansion by domestic economic reforms.

Similarly, both China and Europe is at risk of stalled trade growth unless their economies are opened up to a greater degree than today. China-EU trade is unlikely to grow at high levels in the next decade without reforms. Much of the current bilateral trade potential has been exhausted. Now the task is to expand that potential.

What does this mean for political leaders of trade in China and Europe? Wilhelm Röpke, the late German economist whose views were critically important for the rebuilding of Germany’s economy after the Second World War, once said: “Internationalism – like charity – begins at home”. For a country to be competitive on world markets, and to take leadership in matters abroad, it has to pursue economic policies “at home” that make it competitive. Or to put it in different terms: economic strength comes from having open, not protected, markets.

China and Europe should recover that spirit in their relation. Europe grew much stronger in the 1990s after it had eliminated barriers to exchange internally in Europe. And much of China’s prosperity today is owed to its past leaders that pursued economic reforms in the 1980s and 1990s. We now need leaders who likewise can rise to the leadership required for economic reforms. And if Chinese and European leaders make political investments in each other’s reform ambitions – rather than protecting economies from foreign competition – then they will have established a new partnership for prosperity that will inspire the rest of the world.