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Mercantilist Misconceptions: A Détente Strategy for EU-China Relations

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It is two powers in transition that meets when leaders of the European Union and China gather in Brussels for the 15th EU-China Summit in the second half of September. The current Beijing leadership will soon step down – from their party positions in October and from the government next year. Xi Jinping and Li Keqiang will most likely take helm as President and Prime Minister, respectively.

Less evident, perhaps, the leadership of European Union is also in transition. But it is a transition not about people but the character of European cooperation and the authority it commands. The Eurozone crisis has exacerbated institutional problems and controversies in the EU construct and wrecked the notion of the EU as a convergent economy with shared economic and commercial interests. A group of four presidents of EU institutions has been tasked to work up an institutional remedy. More boldly, the President of the European Commission, José Manuel Barroso, has just thrown down the gauntlet of creating a more federalist union.[2]

It is a scene that conforms to common prejudices about European and Chinese politics. While European policy often is believed to evolve at a glacial pace – through perennial and complicated treaty changes regulating what the EU can and cannot do – many observers look to Beijing in revolutionary spirits, thinking that shifts at the top will have profound consequences for China's political direction. Even if there are some grains of truth in these

SUMMARY

EU-China relations look set to grow increasingly charged in the next few years. Both sides will go through political transitions. We are on the doorstep of an era of political navel gazing that will limit their capacity to fashion a new and much needed cooperative approach towards each other. While China will go through a leadership transition, the EU increasingly moves toward new models of deeper policy integration that will require new treaty changes. Undoubtedly, these processes will take time and foster an introspective political atmosphere.

Both the EU and China suffer from mercantilist misconception that guide how they look at trade and commercial policy. Even if there is a growing understanding in China that greater weight will have to given to other factors than investment and export in its growth model, its foreign economic policy remains under the spell of mercantilism. The crisis in Europe has promoted mercantilist notions and there is an increasing tendency in the European Union to use confrontational approaches to expand foreign sales. This is especially true of the EU's approach to China.

Now is not a good time to reset EU-China trade and economic policy relations. What is needed now is rather a damage limitation strategy – a mechanism to contain a growing number of trade spats, some of which that could escalate into tit-for-tat protectionism.

narratives it seems safe to say that we do not know neither how Chinese politics will be affected by its transition nor where the EU will end up after the crisis and a new period of institutional change.

What we do know, however, is that both transitions will produce an overall atmosphere of political introspection. The next few years will be one of political navel gazing and profound policy uncertainty, let alone policy paralysis. Undoubtedly, such an introvert climate will be reflected in both Europe's and China's external ambitions and preferences, and how they respond to events. Internationalism, said the defunct German economist Wilhelm Röpke, begins at home. And if "home" is in disorder, so is also the international policy.

Consequently, now does not seem to be a good time for the EU and China to reset their economic and commercial policy relation and fashion a new and much-needed cooperative approach. The relation between the EU and China will rather continue to be a source of frictions in the next few years. It will likely grow to become more charged than it is today, with risks of profound policy clashes.

Brussels has recently launched a couple of trade-defence cases that are politically explosive. Its confrontational rhetoric on closing the EU public procurement market for the likes of China – or publicly rehearsing a case for subjecting China's investment in Europe to an EU-based security probe – is a good strategy to loose friends and alienate a country. Europe's clash with China and other countries over new carbon fees on airline traffic outside Europe's airspace has the potential of escalating into a dirty trade war next year when the fees are due to be paid.

China is no better. The advancement of state-interventions in the economy increasingly reverberates in its trade and foreign economic policy. Market access restrictions remain high – and are increasing in some sectors and areas. Foreign business and investors are routinely discriminated in new and arcane non-tariff barriers.[3]

So what should be the strategy for EU-China trade and economic relations in the next few years? This paper argues that both sides need to go back to the drawing board. They need to develop much better cooperative approaches that later could mature into new policy cooperation. Till that happens, the current form of EU-China relations should as much as possible establish strategies to avoid new conflicts. This is a strategy for détente.

POWER AND PLENTY

The human mind seems wired to gauge prosperity in terms of economic power – or the size of an economy vis-à-vis other economies. It is right at the heart of mercantilism – the still influential economic philosophy, or system of power, that espouses the doctrine of accumulating wealth through ever-bigger trade surpluses. For its disciples, power is as important as plenty, if not more. Modern mercantilist notions differ from the dominating mercantilist schools in the 18th and 19th century, elegantly chronicled by economic historians Eli Heckscher and Jacob Viner. They are primarily not the consequence of a crude and untempered quest for dominance or power; they rather reflect a desire for plenty, or welfare.

Yet the mercantilist concept of economic power subtly finds its way into many discussions on the world economy and the rise of China. It is a central tenet in China hype and hyperbole – in the "when-China-rules-the-world" fallacy. And less devout versions of it sneaked into the centre of the Eurozone crisis last autumn when top European policymakers put their faith in China relieving the Eurozone from its fiscal pains by spending its reserves on European sovereign bonds. It was now time for China, argued some, to return some of the money that China has acquired through its trade surplus with Europe.

Still, if history is the yardstick, China's rise to the premier league of modern world economies has been surprisingly smooth – especially so in light of the scale and speed of its development, and the unsubtle mercantilist leanings in its economic policy. Yet China's trade and economic relations with other big economies are increasingly charged, and in the next decade there will arguably be much greater controversy around China's aspiration to become a leading world economy, perhaps the leading one. Mercantilist misapprehensions about "power and plenty" are again the source of friction – this time reinforced by the weak economic performance of the West. China's overall trade strategy remains guided by modern mercantilism. It is not as narrowly defined as before, and the shrinking trade surplus (China's surplus in 2011 was "only" 2.2 percent)[4] suggests that China's predisposition to one-sided export expansion has weakened.[5]

What about Europe? "Let not the world see fear and sad distrust", said the bastard in Shakespeare's King John. And he continued: "Be stirring as the time; be fire with fire". In the past years, Europe's approach – at the national level as well as in Brussels' strategic policy direction – has lurked towards mercantilism. This is particularly true for Europe's approach to China. Mercantilism should now be fought by mercantilism. What started in 2006 as a verbal confrontation China for its bilateral trade surplus with Europe – which, in light of Europe's overall current account balance, never was a credible basis for a U.S. style trade confrontation with China – has now become a defensive, non-cooperative mercantilist strategy. The basic message is: China will lose market access to Europe if Europe cannot export more to China.

MULTILATERALISM AS STRATEGY FOR INFLUENCE

A constant irritation for economists is the widespread use of economic size as a measure of wealth. According to the International Monetary Fund's world league table, the country with the highest Gross Domestic Product (GDP) per capita is Qatar, a small Arab emirate with just a little more than 1.5 million citizens. All the other top five nations in this league are small economies without systemic importance for the world economy. None of them wield any economic power. Of the three biggest economies in the world, only one (the United States) qualifies for the list of the top 20 countries with the highest per capita GDP.

The simple point is this: people do not go to work every morning to expand the size of a country's GDP, but to improve their own welfare. They neither ask what they can do for the nation's economy nor what the nation's economy can do for them. They are active economic subjects because they want to improve their standard of living. None of this is to deny the importance of economic power for other societal ambitions such as peace and war. But many political leaders through history have made the error of judging their prowess in terms of relative economic size rather than prosperity.

Edward Gibbons noted in his magisterial study from 1776, *The History of the Decline and Fall of the Roman Empire*, that "the decline of Rome was the natural and inevitable result of immoderate greatness". In another great intellectual achievement of the same year – *The Wealth of Nations* – Adam Smith commented sardonically: "The rulers of Great Britain have, for more than a century past, amused the people with the imagination that they possessed a great empire on the west side of the Atlantic. This empire, however, has hitherto existed in imagination only. It has hitherto been, not an empire, but the project of an empire; not a gold mine, but the project of a gold mine; a project which has cost, which continues to cost, and which, if pursued in the same way as it has been hitherto, is likely to cost, immense expense, without being likely to bring any profit."

Adam Smith was proven right. But it took another 150 years or so before Great Britain had dismantled its empire (even longer if the exit from Hong Kong is included). From the end of the Second World War onwards, the guiding principle of its foreign policy was rather "managing decline", a derogative term for the adjustment to a new world order with less (and eventually no) emphasis on the imperial system. This was also true for other European countries such as France, whose imperial decline shrunk the size of the economy that Paris controlled.

Yet the post-imperial divestment evolved alongside the formation of new organisations and rules for global commerce and trade. These policy innovations helped to free up global commerce – also outside the imperial systems – and establish rules and norms to govern the international economy and international economic policy. They spearheaded the economic globalisation of the past 50 years – the gradual geographic, functional and sectoral expansion of cross-border trade and investment. Many countries on the European continent went faster and farther. Starting with a Customs Union in 1957, an increasing number of European countries have jointly reduced, if not eliminated, barriers to cross-border trade in the region.

Multilateralism and regionalism helped to maintain the clout that past European powers could draw from their relative economic size. New post-war international economic institutions were underwritten by the United States, but European countries conformed to American leadership, often reluctantly, because in the end many believed they were the main beneficiaries of the new system. Equally important, these countries have increasingly accepted regional integration in Europe as a way to remain influential beyond their own borders. To maintain, let alone increase, Europe's influence in the world has been a leitmotif in many efforts to expand and deepen the European Union.

As Tony Blair, the former Prime Minister of the United Kingdom, recently put it: "The rationale for Europe today is not peace; it is power."[6] Or as José Manuel Barroso expressed this sentiment in his recent State of the Union address: "Sharing sovereignty in Europe means being more sovereign in a global world. In today's world, size matters."

Yet China's rapid economic rise, and its aspiration of having a prominent seat at the table of multilateral economic institutions, has subtly introduced doubt in the U.S. and European view on the usefulness of multilateralism. Their tacit, unspoken quandary is about whom these organisations really should represent. While their readiness to lend grandiose rhetorical support to the idea of multilateralism remains uncorrupted, they increasingly ponder the history of post-war multilateralism: the U.S. and Europe created multilateral economic institutions with the purpose of championing their view of the world economy and economic policy. Their hesitancy is amplified by China's ambiguous view of what it wants to use these institutions for – or, more generally, how it should deploy its newly acquired economic power. And in one sense, European doubts are bigger than on the other side of the Atlantic. While multilateralism was an expedient strategy for influence in the post-war era, Europe is now rather meditating how its own relative decline, accelerated by the Eurozone crisis, will diminish its multilateral influence. Multilateralism is no longer a counter-force to dwindling power forced by relative economic decline.

EU-CHINA RELATIONS: ECONOMIC CONVERGENCE, POLITICAL DIVERGENCE

China has an ambiguous approach to managing its advancement. And Europe is erratically managing its decline. The distance between them is causing friction in trade and economic policy. How will this relation evolve in the future?

The good news is that the China-Europe relationship is too big, and too well developed, to fail. Bilateral economic exchange recovered quickly from the sharp drop in 2008-9, and bilateral trade, despite the overall contraction in the Eurozone, increased considerably in 2011. Even in the event of the growth in trade and investment slowing down in 2012, which is already happening, the European Union and China will still become more tightly integrated. The EU is China's biggest trading partner, and China is the second biggest trading partner for the EU. These basic observations have become increasingly important for economic and commercial policy relations between the European Union and China in the past year. Neither party will allow it to be fractured by serious economic and commercial policy conflicts. It is a sign of the maturity of the bilateral exchange that current volumes of trade and investment cement the relationship.

The bad news is that this defensive interest to protect past achievements is currently one of few things keeping EU-China relations in balance. The climate of EU-China policy cooperation has soured considerably in the past two years. Cooperation on trade and investment policy is fraught by misunderstandings, offended egos, discontent, and anger. In some quarters, and especially in Europe, frustration is reaching boiling point. The EU-China High Level Trade and Economic Dialogue, which followed hard on the heels of the U.S.-China Strategic and Economic Dialogue (S&ED), has largely become dysfunctional, both as a forum for efficient, business-like negotiations on selective market-access issues and as a venue for forming joint strategic visions for future bilateral economic relations. In some policy areas, relations are not far away from a complete breakdown. Key officials do not speak to each other. E-mails and phone calls go unanswered.

Moreover, despite Wen Jiabao's defence of a Chinese role in the European Financial Stability Facility (EFSF) and the smaller sums that have been contributed quietly, Europe's previous hopes of China accepting a greater paymaster role to Eurozone countries with wrecked public finances have withered away. The fact that China has rejected EU calls to invest more in the EFSF, disavowed past promises of considerable bilateral loans to individual crisis countries in Europe, and instead committed itself to increasing its financial support to the International Monetary Fund, is a sign of the frustrated bilateral policy relations between the EU and China. In effect, China has been disloyal to its own core strategy of dealing directly with Europe, preferably through national capitals in a way that allows Beijing to sweeten policy agreements with financial assistance or trade-promotion deals – or, if necessary, through dialogues with the institutions in Brussels. That China prefers to route new money to the Eurozone's crisis arsenal through a multilateral organisation, and one it is suspicious about, is a measure of Beijing's dissatisfaction with Europe.

Both Beijing and Brussels seem content to wait for the new leadership in China to take office before they attempt to deepen economic and commercial policy cooperation. However, the hope that the bilateral relationship will radically improve under a new leadership in Beijing is naive. Individuals matter, but the problems in China-EU relations are rooted in divergent views on state, government and international economic policy. The economic crises in the past years have weakened EU-China relations. Yet their main effect has not been to provoke new economic disputes but to accentuate instincts and characters that were already on display before the global financial crisis.

The EU increasingly embodies Sisyphean traits in its economic and commercial policy posture towards China. Like Sisyphus, condemned to repeatedly roll a huge boulder to the top of a steep hill, the EU has time and again put pressure on China to open up its markets to European exports. Its approach has often been confrontational, threatening China with assorted sticks unless it catered to EU demands. But this strategy has had little payoff. Every time the boulder has approached the top, it has rolled back again. Some member state governments have supported this approach, which has allowed them to play the role of the "good cop". But the EU does not work when it is tasked to drum up protectionist threats. It has neither the treaty support nor the necessary policy tools to carry them through. For instance, the European Commission's recent attempts to introduce a European version of the U.S. Committee on Foreign Investment in the United States (CFIUS), which screens all incoming investments for national security threats, cannot be squared by the Lisbon treaty. Equally important, taking on the role of arch mercantilist/protectionist in Europe goes against the ethos of the Commission. The role of the Commission has always been to find the balance between opposing camps in the EU membership – in this case between free trade and protectionism leaning countries – that allows Europe to gradually liberalise its foreign economic and commercial policy. Beijing knows this and has safely ignored the EU's threats and demands.

Sisyphus' perpetual struggle, said French author Albert Camus in the *Myth of Sisyphus*, has no chance of ultimate success but gives meaning to his life. It is an absurd meaning, but as long as he accepts the repetitious struggle, it gives happiness "enough to fill a man's heart". It may be surprising to some, but many EU politicians and officials are satisfied with the current approach to China, despite the lack of progress. As Camus ended his essay: "One must imagine Sisyphus happy".

China, on the other hand, is more like an Icarus. Having acquired serious market power in the past ten years, China flaunts its new fortunes in its relations with the EU (and others). But China is profoundly uncertain about what it should use its newfound economic power for.

Beijing's ambivalence is symptomatic of what has been a more general strategy of keeping a low international profile, biding its time and avoiding relationships with other big economies that could force China to (prematurely) change this strategy. But this policy does not befit an economy of China's size. When its core foreign economic policy seems confined to securing access to raw materials and maintaining a largely mercantilist trade strategy, China encourages other economies to mistrust it. Like the United States in the 19th century, China has grown to become one of the giants of the world economy, but has yet to accept that its newly acquired systemic importance requires a corresponding and attendant responsibility for the international system of exchange. China's foreign economic aspirations remain an enigma: does Beijing accept a gradual but constant move towards a globalisation based on market-economy principles and shared responsibility for a multilateral system of rules? Or does it want to rewrite that principle?

Admittedly, the question is somewhat metaphysical and unfair. China has largely been a loyal rules-follower during its ten years as member of the World Trade Organisation. Its more limited role in the IMF and the World Bank has more to do with incumbent (European) powers' failure to accept that the world economy has changed. Where China has been involved in writing the rules – like formative phases of G20 responses to the crisis – it has behaved constructively.

Yet there are real concerns over China's direction in international economic policy. And for the EU, the crisis has been a litmus test of China's loyalty to the international economic system. The EU was created by the same post-war trends of economic cooperation that brought about the multilateral economic institutions. But most EU countries, in contrast to the United States, were neither capable nor willing to economically underwrite multilateral institutions. Europe received the benefits from U.S. Cold War economic leadership, but it conditioned its support on Europe receiving at least a proportionate share of the gains. Often it was unwilling to accept new trade or monetary deals when gains were unevenly spread between countries, even if the net outcome was positive for Europe. Europe championed for several decades the idea that it was the main beneficiary of the post-war system of international economic exchange. And many parts of Europe have not yet disassociated themselves from that notion. Consequently, they believe it is unfair that China has gained much more than it has contributed. For many officials in Europe, the EU-China High Level Trade and Economic Dialogue started from the premise that China now would return on some of the gains. When Beijing made it clear that it was not prepared to dance to that tune, irritations in Europe were exacerbated.

But China is not innocent in all of this. It has tried to bypass Brussels in its dealings with Europe. Beijing's officials often claim that they do not understand how EU politics work. This is partly understandable. Confusion about how the EU works has only increased as a consequence of the Eurozone crises. Its post-modern political personality has become entrenched. While many other regions in the world still espouse a classic, Westphalian, modernist view on nation, state and government power, the EU has been in the rival business of substituting modernist government with post-modern governance. Governments in Europe have deliberately and willingly weakened their own autonomous authority and power, even when new pan-European structures of power have proven inadequate. National economic interests are now channelled through Brussels and arduous negotiations between EU member states. The EU is a political construct based on perpetual internal negotiations about what it can or cannot do. Chinese politicians, who are used to hard-power realities and schooled in a one-nation mentality, find working with a centralised Europe both difficult and threatening. In Beijing's view, the EU is unpredictable.

While the EU's complicated structures might be confusing, Beijing's bypassing of Brussels is at least partly deliberate. Beijing prefers to deal directly with big European capitals, even on those issues where policy has been clearly centralised to Brussels, because it has more leverage over individual governments than the Union as a whole. There are short-term gains to be made for China from a divisional approach to Europe. A divided Europe will put less pressure on political change and economic reform in China. But a fractured Europe will have negative long-term consequences for China and its economic interests. Beijing has taken its big power strategy too far for EU-China relations not to be weakened.

Icarus has a lesson for China. Daedalus, according to the Roman poet Ovid, tells Icarus to keep to the middle range and not to fly too high. But Icarus, increasingly hubristic, wonders "what limits there are to his father's invention. He flaps his wings and rises higher – but nothing bad happens." Those watching Icarus from the earth assume the winged creature is a god. What Icarus cannot see is that the wax melt is melting. Soon he plunges into the sea.

China has made a bad bet in assuming that its interests are better served by weak rather than effective centralised policies and institutions in Europe. The divisional strategy may work for yet another few years. But before long China will learn the same lesson as others in the past 60 years of global economic policy: a fractured Europe will be less reliable and predictable, and occupied by intra-continental squabbles rather than designing rules and policies for global commerce.

China's approach to multilateral economic institutions will have to change for its policy relations with Europe, and other parts of the world, not to be weakened. It will have to develop an authoritative idea of how China would like to see them evolve – and to a much greater extent accept that it also has to take a greater guardian role in protecting international commercial policy and rules from erosion. Only fools would argue that China already now possesses the requisite economic, political and institutional capacities to compete with the U.S., and to a lesser extent Europe, to be a global economic leader. But for China to invite a greater degree of trust, Beijing must rekindle its overall economic policy. The state mercantilist policies will have to be moderated – or preferably ditched. That is a big step – but managing a country's advance is often as demanding as managing a country's decline.

Europe, on the other hand, should accept that its influence in world economy matters is shrinking – even faster in the next ten years than in the past decade. But the loss of such power should not interfere with aspirations to expand welfare. The turn to mercantilism in Europe will only serve to speed up its relative decline – and as soon it distances itself from such erroneous beliefs it will improve its capacity to grow its welfare. Its recent strategy of bullying China to acquiesce to Europe's demands should be buried. It is leading nowhere and Europe's leverage over China has diminished fast. China's economy adds another Greece to world GDP every twelfth week. Europe has lost a couple of Greece's in the past years. Many Eurozone countries will exit this decade in a poorer state than when the decade started. Such simple arithmetic suggests the EU should choose a cooperative approach.

A NEW STRATEGY OF DÉTENTE

In the meantime, EU-China relations should focus on establishing a damage-control strategy, mechanisms to manage all the flare-ups and the risk of a slide into tit-for-tat protectionism. This does not require any changes in the institutional set up of the EU-China trade and commercial policy dialogue. But there will have to be changes ranging form the political level to agenda formation. Three aspects are central.

First, both the EU and China must be represented by institutions that command authority and have political support from the highest levels. This may sound very banal, but it is not. Trade and commercial policy dialogues between the EU and China should be conducted by the European Commission's trade directorate and China's Ministry of Commerce. The position of both institutions have been weakened in recent years. China's Mofcom no longer has the standing in Chinese politics that it had in the late 1990s and first half of the 2000s. Beijing's top leadership are often hesitant in their support for Mofcom's views when they call for liberalisation or other forms of policy deals with other countries.

The Commission's DG Trade has been weakened by competition between member states of getting good commercial contracts with China and their willingness to trade their positions on intra-EU matters in exchange for foreign sales to China. They have also been acting unfairly with the Commission insofar as they have supported a more confrontational approach towards China – an approach that was flawed already from the start – but undermined that position when the general approach has manifested itself in new initiatives. Blame should also be put on the doorstep of the Commission. It should have been clear for the first time it ventured into a confrontational stance that this would prove divisive in the EU membership and that powerful countries would block concrete policy initiatives. Now we are at a point when the Commission's authority, especially in matters regarding China, has to be restored.

Second, the agenda for the dialogue have to centre upon the politically charged areas. EU-China dialogues are too often political white-gloves affairs that pay little attention to the difficult issues. Officials regularly meet to discuss them, but absent attention at the political level also the junior dialogues become charades. Political summits have often been choreographed in advance of the meeting. Astonishingly, only a few politicians and senior officials, on both sides, really know their counterparts and have developed an understanding of them that go deeper than the immediate surface.

Third, there must be a willingness to have senior discussions and consultations with each other before major policy initiatives are launched. Even if the other side has expected most of the controversial initiatives that have been launched in the past years, there has not been any genuine dialogues and consultation at appropriately high levels about them before they have been launched. China's policy initiative on indigenous innovation is one example. Another example is Europe's extraterritorial application of airline carbon fees.

Such consultations are central. Even if they do not lead to accommodations of the other party's views, they can foster a much better understanding of what is planned, and why. Today, the degree of misunderstandings and misconceptions about the position of the other side is vexingly high. Perhaps you could find excuses for such a situation ten years ago. Now the economic relation between the EU and China is far too important to be left to diplomatic second-guessing.

ENDNOTES

1. This paper draws on Fredrik Erixon (2012) *When Sisyphus met Icarus: EU-China Relations during the Eurozone Crisis*. Washington, DC: German Marshall Fund of the United States; and Fredrik Erixon (2012) "The Balance of Sino-European Power" in Boao Review, July 2012.
2. José Manuel Barroso (2012) State of the Union 2012 Address. Accessed at http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/12/596
3. The new position paper form the EU Chamber of Commerce in Beijing presents a thorough analysis of market access restrictions and discrimination in China. See EUCCC (2012) Position Paper 2012/13, September 2012. Accessed at http://www.euccc.com.cn/upload/media/media/28/Final_EN_Position_Paper_2012%5B774%5D.pdf
4. China's trade surplus of 117 billion euro in 2011 trailed Germany's trade surplus of 158 billion euro.
5. However, this is not to say that China's growth has been export-driven, just that the Beijing officialdom has suffered from mercantilist misapprehensions.
6. Lionel Barber, "Waiting in the wings", Financial Times, Saturday June 30/Sunday July 1, 2012

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