

Fredrik Erixon, Director and Co-founder, the European Centre for International Political Economy (ECIPE), a world-economy think tank based in Brussels

Speech at the Eight Forum on the International Competitiveness of China's Industries

Your Excellences,

Ladies and Gentlemen,

Dear friends,

It gives me great pleasure to address the **Eight Forum on the International Competitiveness of China's Industries**. In the past ten years, a central part of my own work has concerned the rise of China to the premier league of the world economy. China's economic development – profoundly supported by its orientation towards the world economy – has been magnificent, and it has generated increased prosperity in China and among its trading partners. It should be a source of appreciation across the world.

However, one of the reasons why I am speaking at this conference is that China's economic rise has spawned defensive political attitudes in Europe – and other parts of the world – attitudes that occasionally has been manifested by protectionism. And the subject I plan to talk to you about is how Europe is likely to approach China in economic and trade matters in the next few years.

I have two hypotheses that I want to present to you.

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First, unless there are changes in trade and regulatory policy in **both** Europe and China, the next ten years in China-EU trade relations are likely to become fraught with political tensions – much more so than in the past ten years.

Second, the new tensions that will arise are likely to be different from the ones experienced in the past decade. They will also require different policy responses if we want to contain them – to avoid that they escalate into larger systemic problems.

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My conclusion is that leaders in both China and Europe should act in a forward-looking manner and design policies to ensure stable and increasingly prosperous trade relations. However, that is easier said than done. It would require substantial reforms in both Europe and China for bilateral trade growth to continue at elevated levels. Regrettably, there is not much evidence of such a reform-intensive development. And if that observation is correct, it also follows that the design of bilateral trade relations between China and Europe has to be structured on defensive rather than offensive lines – to protect what has been achieved rather than aiming for greater accomplishments.

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Let me start, however, on a positive note – and to give some more context on China-EU relations

Today, the China-Europe trade relationship is “too big to fail”. 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, 75% of its import from China is input goods and this import has helped European firms to cut production costs and made Europe’s own export more competitive.

So this trade relation is a success story – proving age-old wisdoms about the gains from trade. 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 this relation 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 a new common strategy to contain protectionist pressures, address legitimate concerns on both sides, AND, which is important, support or reflecting new economic reforms in China as well as in Europe.

Yet recent months and years have seen several examples of how China-EU trade increasingly gives rise to political friction. Europe, in particular, has been the source of contingent trade-defence approaches. New trade-defence cases in high-profile sectors like telecom equipment and solar panels have recently 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 cherished European sectors from the embrace of Chinese Foreign Direct Investments.

Such attitudes to commercial relations with China are regrettable. At the same time, one should not exaggerate their significance. More importantly, 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 recent 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 innovation.

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 are causing frictions in the bilateral relation. It is difficult – if not impossible – to address these frictions by diplomatic actions in 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.

So what does this mean for political leaders of trade in China and Europe? Wilhelm Röpke, a 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 and competitive, 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 can find a format of cooperation making political investments in each other's reform ambitions – then they will have established a new partnership for prosperity and harmony that will inspire other countries, too.

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This leads me to my first hypothesis.

Despite what I just have said, my analysis is that the agenda for economic reforms in both Europe and China will be tentative and selective – at best. It will be surrounded by increasing political confrontation, undermining the capacity of leaders to actually pursue economic reforms.

I am not here to lecture you about China – so let me use Europe as evidence for my hypothesis. I have a couple of concerns.

First, many countries in Europe need to go through a period of root-and-branch economic reforms, and some of them are now reforming fiscal policy in order to avoid sovereign debt crises. But the reforms target fiscal deficits and public debt. Countries have done very little to speed up growth and competitiveness reforms. **In fact**, many countries have undermined their growth potential by raising taxes on productive forces in the economy – in the spirit of austerity. And as basic economics will tell us, higher taxes on capital and labour will translate into greater difficulties to generate higher returns on capital and labour.

Moreover, while fiscal consolidation is necessary, the current agenda for adjustment inside the Eurozone is depressionary and deflationary. The theory is that the competitiveness of failing economies like Greece and Portugal will improve by wage cuts – by falling income. Such wage depression may work over time, at some point the economic contraction will bottom out, but it will also put these economies closer to China's in terms of costs. If this theory of adjustment holds true, it is not by pushing its own comparative advantage vis-à-vis China that European countries will recover and grow, but by becoming more like China in terms of production cost.

Second, the pan-European reform agenda – in the European Union – has stalled. There is very little appetite to free up cross-border exchange within Europe. The dominant trend now is rather one of heightened regulations of capital, labour and resource markets, like the energy sector. There is much talk about new single market reforms and agendas left, right and centre to make Europe the most competitive economy in the world. But they simply don't deliver.

Third, the capacity of the European Union to lead on an outward-looking policy for trade and globalisation has diminished in recent years, not least because of increased economic divergence between member states of the EU. This trend undermines unity in the European Union – and it is likely to increase in future. While some countries – like Germany and other countries in the Northern part of Europe – are well equipped to benefit from continued economic expansion in Asia, many countries in the Southern part of Europe do not have an economic profile that is easily compatible with the continental economic awakening in Asia. Already today, one country in the Eurozone alone – Germany – represents more than 50

percent of all Eurozone exports to China. Worryingly for Eurozone unity, this share is likely to rise.

Finally, Europe's fiscal and financial problems are likely to last for another decade or two. The acute Eurozone crisis will abate earlier, of course, but countries will still be in a process of paying down debt, and this will weigh down domestic consumption. It will seek greater access to export markets like China in order to generate more sales and growth. But it is less willing to achieve such new access in a cooperative, reciprocal manner. The old spirit of mercantilism has yet again taken hostages in European policy – it is pursuing an agenda of one-sided trade liberalisation, where other countries should open their markets without getting something in return from Europe. Predictably, such a policy will not work.

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Let me now turn to my second hypothesis – that the character of the frictions in China-EU trade relations will be different in future than they have been in the past.

My point is this – while past frictions have concerned resistance to competition in Europe's sunset industries, frictions will now emerge in what it views as its future sectors. In the past, trade frictions have emerged in sectors like light industry, electronic equipment, textiles and garments, footwear, plastic bags and others in which labour costs define the comparative advantage or disadvantage. In the future, frictions are more likely to concern high-tech, capital-intensive sectors that are sensitive to the quality of regulations and intellectual property rights.

My question mark here is not so much over Europe as it is over China. My question is this: will China be able to progressively reform its trade and regulatory policy to make it more compatible to market-led processes for *value* creation? Or let me phrase the question differently: while Chinese firms have been extraordinarily successful in competing with foreign firms in rationalising *supply chains* in the goods sector – will it be equally successful in fostering a climate of successful enterprise in *value chains*?

This is not a new issue for China's political leaders. It has been recognised for many years that the value-added created per unit of trade should increase. The path to prosperity is not to be the "factory floor of the world", but to become an "innovation lab in the world". I also

think China, eventually, will be successful in fostering such a climate of value-creating enterprises. It has to succeed in order to avoid what has been called the “middle-income trap” – to avoid becoming yet another country that managed to take off economically but not the subsequent transition from a middle-income society to a high-income one.

Such a transition requires another type of economic reforms than those that generated the first wave of prosperity. In the initial wave, *first-generation reforms* of trade and product markets spurred economic activity. In the new wave, what is required is *second-generation reforms* that liberalises so-called factor markets – capital, labour, resources – **and** that reduce behind-the-border and regulatory restrictions to trade and investment. Such reforms are important to unleash the forces of innovation and higher value creation. Importantly, they foster value creation at home, by domestic firms, as much as opening up the economy to more international partnership and cooperation – between firms as well as between countries. In essence, these reforms aim to make a country’s economy compatible with value creation in modern international business. And they rest on a logic which has been proven time and again in modern economic history – the more capital-intensive that a country’s production become, the more it has to rely on private forces of investment, competition and international exchange. Open trade is always a *win-win game*, but a policy based on restrictions and defensiveness in capital-intensive sectors is for sure a *lose-lose gambit*. It is a waste of resources.

China has taken tentative steps to reinforce its capital-intensive sector. But I hope that I do not stretch your generous hospitality too far when saying that China has a long way to go in accomplishing such reforms. The longer it takes, the more friction it will also find in its relations to Europe. The export gains that Europe can derive from closer trade integration with China are predominantly in capital-intensive sectors. If those gains will be limited, or even reduced, Europe’s mindset will turn even further in a defensive and protectionist direction.

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The conclusion that I draw is that there is a very strong case for deepened trade and commercial integration between China and Europe. Both sides would stand to gain from

continued economic reforms on both sides – and from a rekindled strategy for bilateral cooperation.

I am afraid that this agenda will not materialize. Economic reforms will at best be selective and tentative. And trade policy in both regions suffer from diminishing expectations – few believe anymore that trade can be as strong a vehicle for growth as it has been in the past.

There are also developments on both sides that for the time being will affect the ability of bilateral strategies to deliver much result. China is in the middle of a leadership transition. Less evident, perhaps, is that the leadership of the 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's as a convergent economy with shared economic and commercial interests. In the forthcoming years, the EU will be occupied by managing and remedying its economic crisis and political divergence through new institutional reforms.

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 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. But 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. But at some point it should. There are huge gains to both sides from deeper integration fostered by new waves of economic, trade, and regulatory reforms. Till that moment arises, the key task of China-EU relations should be to develop structures that could contain trade frictions and stop them from escalating into bigger and systemic crisis. That, too, is a tall order. But it is one that will become increasingly important if my two hypotheses prove to be accurate. Looking at it from a European mercantilist point of view – the past ten years exposed European mid-tech industry to forceful competition from China, but Europe's export to China could also grow fast in key sectors. The perception now is that competition will be in sectors where Europe thought it would gain from trade with China. And it certainly will. But not to one with a mercantilist mindset.

Thank you.