Containing Sino-European protectionism

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Abstract

The trade politics of EU-China commercial relations have sharply deteriorated in the last year. Obsessed by its trade deficit with China, European leaders have become shrill and confrontational in its approach to China. China has contained its irritation over EU's China-bashing, but has overall slowed down its trade liberalizations. The EU and China must find a new way to contain protectionist threats in its trade and investment relation.

Key words: EU, China, protectionism, trade liberalization, bilateral relations

In late April the EU and China launched in Beijing a new High Level Economic and Trade Dialogue Mechanism, which is purported to offer a fresh start in their bilateral trade relation. Despite close, increasing, and mutually beneficial trade and investment integration between Europe and China, overt and covert threats of protectionist initiatives have lately been measured up on both sides. Frustrated by EU's soaring bilateral trade deficit with China, Peter Mandelson, the former EU trade commissioner, last autumn warned China of this 'policy time bomb' and what would happen unless China did something to stop the ballooning deficit. The time for soft talk with the 'juggernaut' was over. European leaders have accused China of currency manipulation and governments have introduced investment legislation targeting countries like China. An increasing number of China's export goods have difficulties with product-safety regulations and other standards, which lately have erred on the side of protectionism.

China, for its part, has contained its anger over Europe's new China-bashing, but did not do much to prevent it. New certification requirements that discriminate against foreign producers have recently been introduced. Some tariffs have increased. Beijing's increasing willingness to use China's giant capital reserves for industrial policies (subsidies to firms) have diluted previous ambitions of strong and sustained market liberalisations. China's programme of root-and-branch trade and investment liberalization has clearly slowed down, and in some instances event reverted, and it is about to become a 'normal' country after a decade of unprecedented trade reforms pre and post its WTO accession in 2001.[1]

Europe and China need to establish a new format for trade-political relations. Their commercial relations are too important to become hostage to political grandstanding or airy rhetoric by politicians performing for its domestic gallery. Europe is China's largest export market, and China now ranks second on Europe's list of key trading partners. Trade with China dwarfs any other trade

[1] Erixon, Messerlin & Sally (2008) assess China's post-WTO accession policy.

relation Europe has with emerging Asia. European firms have invested close to 100 billion USD in China, and they generated total sales of more than 130 billion USD in 2006.

Disturbance of this relation have ramifications for sales, growth and employment. Carrefour, the French food chain, recently experienced a boycott after French critique over China's policy towards Tibet. Any Western multinational company operating in China is cautious in its approach to Chinese politics in order to avoid hostile political reactions from Beijing as well as consumer boycotts. The Chinese government is less concerned today of Western critique against China's autocratic system, but the Chinese people has grown more nationalistic and represents a potentially greater threat to commercial relations.

Commercial interests in autocratic regimes cause political dilemmas. On the one hand European and other Western governments need to voice its critique and tailor policies that take account of human-rights violations. On the other hand they have commercial interests to defend. Furthermore, their overall policies must be measured in order to avoid diplomatic brinkmanship, which risk leading to the opposite outcome: a slow down, let alone reversion, of freedom reforms.

An effective strategy towards China should take account of foreign-policy objectives as well as commercial interests. They should, however, be separated. As the EU-China summit in Beijing gave proof of, it is possible to address China's policy in Tibet, as well as other concerns, without damaging commercial relations. Yet it is foolish to believe that Beijing will overturn its autocratic regime if Europe or the United States threaten to cut off Chinese companies from their markets. Such attitudes rather put the Chinese backs up and lead nowhere. As China's integration into the world economy has stimulated greater freedoms in China, Western governments should tailor policies which deepen economic integration and make a greater part of China's population dependant on other markets. Other tracks of bilateral relations should be used to address political concerns; commercial-policy relations should deal with economic and business concerns.

A new bilateral approach

If taken seriously by the Chinese and the European leaders, the new High Level Economic and Trade Dialogue can break the trend of souring relations. Evidently, this is the result of the US-China Strategic Economic Dialogue, which Hank Paulson, the US Treasury Secretary, initiated in late 2006. American firms, especially in the financial-services sector, have been granted better access to the Chinese market, one of the most liquid markets in the world. Banks can now issue cards in local currencies, and securities firms can now trade in local currency. Nasdaq and the New York Stock Exchange has been allowed to open branches in China. Equally important, the US-China dialogue has contained the slide towards China protectionism in the US Congress.[2]

If the EU-China dialogue achieves nothing but a containment of protectionist pressures on both sides, it would be valuable as there is a clear risk of mutually enforced tit-for-tat protectionism. However, if the agenda is appropriately tailored, the new bilateral talks could solve commercial problems, oil negotiations, and create a positive atmosphere for the launched-but-sleeping negotiations of a Partnership and Cooperation Agreement (PCA), which involves an upgrade of the weak 1985 commercial agreement, between China and Europe.

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[2] Dreyer & Erixon (2008) map the outcome of the US-China Strategic Economic Dialogue.

A virtuous cycle of openness will not be created by default. What should China and Europe do to ensure that the new dialogue, and the forthcoming PCA negotiations, does not become a talkfest?

Firstly, the talks must start from a proper appraisal of current trade and investment relations. More than anything else, this requires that Europe drops its obsession with its bilateral trade deficit to China. This deficit has grown rapidly and hit approximately 190 billion euro in 2007. Yet, Europe has benefited much from trade with China and the notion that a *bilateral* deficit represents a problem which must be corrected is simply bad economics. In contrast to the United States, Europe's overall current account is in balance and has stably remained in the one-plus or one-minus region (of GDP) for the last ten years. If a bilateral deficit really constituted a problem, Bulgaria, France, Romania, the UK, and several other trade-deficit countries in the EU should rather be worried of their deficit in trade with other European countries, which dwarfs their deficit in trade with China.

But there is more to the story than meets the eye. EU's trade deficit with China largely mirrors replacement of other countries' export to Europe. In other words, China's increasing export to Europe has been accompanied by falling exports to Europe from other emerging countries. For example, in a typical sector of EU-China trade, machinery and transport equipments, China's surplus with Europe has increased with 50 billion euro since 2000. But EU's import from other emerging economies of goods in the same category has decreased with nearly as much in the same years. Similar patterns exist in other categories of trade: China replaces other trading partners.

In the last decade, China has established itself as a hub for Asia's trade with Europe. Supply chains in multinational firms have been fragmented to take advantage of lower labour costs and specialization skills in various countries. A large part of China's export is therefore based on import – and this import is necessary for China to export. Processing trade, which is economic jargon for the refinement of an imported good before it is re-exported, has been a core part of China's outward-oriented export-development model and is estimated to represent between one half and two-thirds of China's total exports.

Thus, China's increase of export to Europe does not equal a fall in Europe's production. In fact, the typical export good of China to Europe is from a sector in which Europe has not had comparative advantages for a long time, which means that Europe could only resume its own production at the expense of its own welfare (as it would need stop producing some of its current production). Furthermore, globally-oriented firms in Europe have been given better opportunities to increase their competitiveness by trading with China. Stronger demands by Europe on China to correct the deficit, by trade or macro-economic measures, will, if realized, lead to falling welfare for both. If China, for example, was forced to appreciate its currency towards European currencies with 30 percent, which has been suggested, the main effect would be that European consumers would have to pay more for fewer goods. The deficit itself would not change much. Furthermore, the ensuing higher cost for input goods would push the price of European export.

Secondly, China and Europe should tailor an agenda for the new dialogue and the PCA negotiations which facilitates a give-and-get bargain of trade and investment openings. Such an aim is important. Inevitably EU-China talks must start from the basics: China's WTO commitments. Europe has legitimate commercial concerns that to some extent go back to China's accession to the WTO and problems of meeting the commitments then agreed to. The concerns regard China's remaining tariff liberalization and enforcement of intellectual property rights.

Yet the EU-China talks cannot end there. If the ambitions are not higher than implementation of WTO commitments, the likelihood that China will change its policy in these areas will certainly be smaller. More important, both parties will sign off an opportunity to achieve further deepening of commercial relations which go beyond WTO commitments.

Mapping an EU-China bargain

Thirdly, the negotiations should focus on the areas which cause real frictions in the current commercial relations. There are irritations and demands on both sides. Europe particularly wants increased access to Chinese service markets, which are considerably protected, and better tailored policies to prevent infringements of intellectual property rights in key areas of innovation, such as pharmaceuticals, and through forced technology transfer. These two areas also hang together. For European services to enter the Chinese market, or sign contracts with Chinese service input suppliers, there need to be a better enforcement of key intellectual property rights as many services have IPRs at the centre of their business model. For many firms in the financial, software, and telecommunications sectors, it is today too risky to invest in China as their intellectual property is likely to be infringed. Better and targeted enforcement of IPRs are also in the interest of China. If Chinese firms want to climb the value-added chain and become a hub also for services trade, Beijing must give better assurances of IPR protection.

China desires better discipline in EU's anti-dumping policy and wants to be granted so-called Market Economy Status, which would prevent the EU from using some of the 'innovative' and highly dubious techniques available to motivate anti-dumping duties. China justifiably feels that its companies are not fairly treated in Europe's anti-dumping policy. In 2007, a year of deliberate restraint in the launch of new anti-dumping investigations, China was highly represented in EU's trade-remedy activities. In fact, European anti-dumping policy appeared to be a China policy. Chinese companies were involved in all six new anti-dumping investigations (in only one case were companies from other countries involved). Of the six investigations that in 2007 concluded with the imposition of provisional duties, Chinese companies figured in four. Of the eight cases that concluded in 2007 with the imposition of definite duties, Chinese firms were involved in seven. As EU's trade-defense policy is gaining speed again, with an increase in the number of new cases, China's concern is understandable.

Furthermore, China is overall concerned with EU's contingent protection against export and investments from China, and wants disciplines to avoid hidden protectionism. The Chinese sovereign wealth funds, especially the China Investment Corporation which controls approximately 200 billion USD, and demands on them to display corporate-governance structures are naturally part of this concern.

Yet Chinese concerns are less about SWF's, which typically only acquire small stakes in companies or in funds, and more about its outward-oriented companies, some of which are awash in cash and in search of companies to buy in Europe. China also knows that while European governments eagerly welcomes foreigners investing on the stock exchanges, they are wary of foreign companies buying entire companies, especially European 'champions' or those previously owned by a government. What China especially requires from Europe is better disciplines on governmental action in so-called 'pre-establishment phases' of a merger or acquisition (when an investment is made). Post-establishment phases are generally well-governed in Europe (partly because governments have subjected these matters to single-market disciplines), but governments have recently interfered on several occasions when foreigners have been involved in mergers and acquisitions. Furthermore, some European governments have introduced "poisonous-pill" regulations, which immediately slow the acquisition process down when a foreign investor is involved. Other countries, like Germany, toy with the idea of introducing more far-reaching legislation.

Europe's and China's core commercial concerns are legitimate. They can also be addressed in bilateral negotiations. These negotiations should be sequenced: a smaller bargain can be achieved in the new EU-China dialogue and a larger bargain can be facilitated in the forthcoming PCA negotiations.[3] To be made possible, however, it is also required that political leaders adopt a constructive approach and stay away from political grandstanding and empty phraseology.

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[3] Messerlin & Wang (2008) outline a sequenced bargain between Europe and China.