EU-China Economic Relations: trade and investment tensions persist despite climate cooperation

The EU-China economic partnership continues to under-perform with no easy solutions in sight. The failure of the 19th EU-China Summit in June 2017 to issue an agreed final communique points to deep-seated areas of ongoing tension linked to economic disagreements that remain unresolved. There had been hopes that the notification by the US government of its intention to withdraw from the Paris Climate Agreement could give China's relationship with the European Union (EU) much-needed impetus to build on their strategic partnership by acting as a stimulus for both sides to come together. However, such optimism appears to have been misplaced.

Behind the summit headlines there continues to be deep-seated disagreement between the EU and China over economic policy areas and compromise by either side will be difficult for a variety of important political reasons. Tensions in the bilateral relationship are most keenly felt in areas such as reciprocal market access, trade imbalances, accelerating Chinese foreign direct investment and the continuing refusal of the EU to grant market economy status to China under WTO rules. The current state of affairs can best be captured by three words: trust, reciprocity, and opportunity.

Taking the positives first, there remains genuine opportunity for both sides. The value of trade in goods between the EU and China reached almost €1.5 billion *per day* in 2016 according to figures from the European Commission. Similarly, foreign direct investment from China into the EU surged by 76% in the same year to €35 billion with growing Chinese interest in Europe's advanced machinery, ICT, transport and infrastructure sectors. Similarly, there has been positive rhetoric about Chinese contribution to the EU's so-called 'Juncker Plan' of growth-stimulating investment, which China maintains can complement their own much more ambitious 'One Belt One Road' initiative that may originate in East Asia but targets the heartlands of Eastern Europe.

Yet arguably, it is actually the level and growth in these economic numbers that helps to explain many of the current tensions, feeding into a growing trust deficit within the EU over China's direction of travel. There are five areas in which current problems are particularly acute.

First, goods trade statistics show that the EU continues to face a significant trade deficit which the European Commission argues is reflective of an absence in fair reciprocity of market access with China that could be better balanced by both a greater commitment to opening up of key industrial sectors and a growth in services trade from its low levels of around 10% of the value of goods. In particular, EU officials point out that Chinese barriers to entry in services are most noticeable in those areas in which Europe has a distinctive competitive advantage were rules of entry to be brought in line with China's WTO commitments, such as banking, finance, legal and business services, implying that an EU-China Free-Trade Agreement is still some way off. By contrast, the EU and Japan have already reached an agreement in principle over key areas covered by the EU-Japan Economic Partnership Agreement.

Second, foreign direct investment flows (FDI) from China into the EU has been accelerating recently, especially through acquisition of technology in particular Member States with vibrant knowledge-led sectors. Germany saw Chinese FDI transactions rise from just over €1 billion in 2015 to €11 billion during 2016.[1] This has led Angela Merkel to express concerns about unfettered acquisitions of valuable European technological know-how by future competitors, although such a negative viewpoint is not universally shared by all German business groups. Whether this kind of adverse sentiment will eventually lead to an EU-level initiative akin to the United States' oversight committee on foreign investment (CFIUS) remains unclear and the EU's Trade Commissioner has

[1] Thilo Hanemann and Mikko Huatari, 'Record flows and Growing Imbalances: Chinese Investment in Europe in 2016', Rhodium Group, January 2017.

publicly emphasised that no decision had yet been made (which of course is not the same as saying the issue is off the table). Any such move in this direction would represent a major new development and would be clearly against China's long-term interests as it seeks to fill gaps in its own innovation capabilities to support future economic growth.

Third, the EU argues that product dumping by Chinese firms of goods produced at below market costs continues to harm European interests and justifies ant-dumping enforcement measures whereas the Chinese maintain that these measures are wholly unjustified and represent continued EU protectionism. Steel is an especially sensitive case where significant and sustained overcapacity in the Chinese market, caused by falling domestic demand as the Chinese economy rebalances from state infrastructure spending, has led to a global glut and serious price pressures. The EU maintains that China's pledges to tackle this overcapacity fall far short of the direct action necessary as part of wider reforms to restructure supply-side stimulus.

Fourth, the role of Chinese state-owned enterprises (SOEs) in trade and investment activities with EU Member States is becoming more problematic given widely available subsidies that these entities continue to enjoy in inputs such as preferential access to finance, flexible land use rights and subsidised energy costs. Whilst some EU countries are not immune from supporting SOEs themselves, EU regulators argue that an absence of meaningful competitive dynamics in SOE-dominated sectors in China, even from Chinese-owned private sector rivals, takes SOE visibility to new levels. These structural conditions such as these help to explain why the European Commission so strongly maintains that China should not be accorded market economy status by the EU at the WTO, despite legal advice to the contrary.

Fifth, the EU is concerned that economic reforms in China have stalled. The rule of law in offering a fair and equal level playing field for all economic actors and in all kinds of business transaction is one that previous Party Plenums of China's ruling Communist Party (CCP) have long supported, yet what the Chinese refer to as 'rule of law' is philosophically different from what Europeans accord to the same words. In China, there is certainly plenty of law but its application is more 'rule by law', with the Party as always supreme which can lead to overt instrumentalism in applying rules. For example, the UK government has noted challenges relating to the application of anti-monopoly legislation in respect to foreign firms,[2] whilst EU business groups complain about enforced joint ventures, unreasonable technology transfer requirements and an ongoing lack of clarity in business operations. Indeed, China continues to underperform in international league tables as a destination for doing business, ranking 78th out of 190 countries according to the World Bank.[3] In fact, close examination of detailed data reflects an even worse position for China in some important metrics, such as in respect to protecting minority investors (arguably very important for joint ventures), where China ranks 123rd.

Perhaps the most intractable question is what should be done about these issues? How can the tensions be relieved and the bilateral relationship improved? Possible answers pose considerable difficulties as remedial action presents challenging political dilemmas for both China and the EU.

Europe needs to agree on a unified stance towards China's economic reach across the continent but struggles with the variable geometry of EU decision-making and differences between Member States about whether to design consumer-friendly versus producer-friendly trade defence priorities in engaging China.

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[2] Exporting to China, Department of International Trade https://www.gov.uk/guidance/exporting-to-china (accessed 5th July 2017).

[3] Doing Business: Measuring Business Regulations, World Bank Group http://www.doingbusiness.org/rankings (accessed 10th July 2017).

The direction of further economic reform in China is itself contested within the CCP in continuing debates over the degree to which supply-side or demand-side adjustment should be prioritised, and in what ways, and in which sectors. China's SOEs connect the Party to the economic performance legitimacy upon which its regime security is based and is therefore not something to dismantle just at the behest of overseas demands. There is also no current evidence to suggest that any change in the scope of future Chinese reforms that could emerge after Xi Jinping commences his second term of office in charge of the CCP later in 2017 would satisfy the demands of Brussels.

The conclusions drawn from this analysis are that no early solution to these tensions is likely and a prognosis of ongoing frustration and continuing disappointment in the future prospects of bilateral relations can be expected.