The Politics of EU-China Economic Relations

An Uneasy Partnership

John Farnell and
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John Farnell
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List of Abbreviations

ADA	Anti-Dumping Agreement (WTO)
ASCM	Agreement on Subsidies and Countervailing Measures (WTO)
AIIB	Asia Infrastructure Investment Bank
CASS	Chinese Academy of Social Sciences
CCP	Chinese Communist Party
DG	Directorate-General (of the European Commission)
ECB	European Central Bank
EEAS	European External Action Service
EFSI	European Fund for Strategic Investment
FDI	Foreign direct investment
GDP	Gross domestic product
IMF	International Monetary Fund
IPR	Intellectual property rights
MES	Market Economy Status
NDRC	National Development and Restructuring Commission
OECD	Organisation for Economic Cooperation and Development
PBoC	People's Bank of China
PCA	Partnership and Cooperation Agreement (between the EU and China)
RMB	renminbi
SDR	Special Drawing Right (of the IMF)
SOE	State-owned enterprise
TPP	Transpacific Partnership
TTIP	Transatlantic Trade and Investment Partnership
UNCTAD	United Nations Conference on Trade and Development
WEF	World Economic Forum
WIPO	World Intellectual Property Organisation
WTO	World Trade Organisation

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PART I

EU–China Relations in a Global Context

CHAPTER 1

A New Economic Relationship in a Changing World

Two of the three largest economies in the world, China and the EU, are rethinking their economic relationship, after decades of moving closer together. The future direction of that relationship will have major implications for the world economy, not only for China and Europe.

The last two decades have seen an extraordinary change in the economic weight and prospects of the EU and China. The EU has experienced steady erosion of its global economic importance and its self-confidence as an economic and political entity. China, by contrast, has taken a more commanding position on the world stage, as an economy set to rival that of the USA within the next ten years and as a political and military power determined to assert its interests within Asia and beyond. The Chinese and European economies have become interdependent since China's re-emergence, and in some areas, interdependence is still increasing. The political mood of the China–EU relationship, however, has changed. The EU's original vision of itself as a missionary for open markets and democratic political systems addressing a China ready to listen to its advice has lost all credibility. Meanwhile, China has become more active in promoting new international economic institutions and alternative economic models to those of the developed world.

During this period of change, the EU and China have sought to enhance their economic and political relations. In 2003, they committed themselves to developing a Comprehensive Strategic Partnership, in which they would not only seek to improve their already close economic ties but

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also consult on political and security issues and cooperate across a wide spectrum of common interests, ranging from research and education to environmental issues to "people-to-people" dialogue. Twelve years later, it is widely acknowledged (if not yet officially) that the results of the Strategic Partnership have been disappointing. Whilst contacts between the two sides continue to multiply, there has been little fundamental change in the structure of their economic relationship, which many in Europe see as "one-sided," and no major policy decision by either side that has offered the prospect of such change. More frequent dialogue may have increased mutual understanding, but no major step towards genuine mutuality and cooperation has been taken that goes beyond multilateral commitments. Economic exchanges are no longer growing at the hectic pace of the first decade of this century, and attempts to extend China–EU cooperation into new areas have so far failed to show results. Today's debate within a number of EU Member States about the potential risks of allowing Chinese direct investment to increase, when an overall increase in infrastructure investment is badly needed, illustrates that, for many people in Europe, China is different.

This book examines the political factors within the EU and China that may explain the apparent stalling of the EU–China Strategic Partnership in economic terms, and offers a more realistic prognosis of how the relationship might develop over the coming years than can be obtained from official communications.

As the following chapters show, the background conditions for close cooperation and productive interchange between China and the EU are favourable in many respects. The economic challenges facing both economies are similar: a deficiency of natural resources, an ageing labour force, pressure for industrial restructuring, and the creation of new jobs through innovation. Each side's economic policy goals, whether defined in Five-Year Plans or the EU's 2020 Agenda, contain similar commitments to promote innovation in knowledge-based industries, to ensure environmental sustainability, to improve education, and to deliver cost-effective health services and social protection. The two sides speak the same policy language, at least on the surface.

They also have complementary assets. Europe has technological and organisational expertise in many areas that could make a critical contribution to China's economic growth, whether in emerging industrial technologies, environmental or health services, or the operation of financial markets. China has surplus capital that it wishes to invest profitably around the globe, at the very time when Europe is looking to renovate its ageing infrastructure and to raise more capital for the expansion of innovative companies. It also has an increasingly skilled and well-educated workforce. A combination of European ideas or expertise and Chinese capital and skilled labour could be a winning combination, if such collaboration could be made to work. The EU also has the distinct advantage of not being perceived by China as a rival regional power, and indeed, not as a power at all in the traditional sense.[1]

The thesis of this book, however, is that this promising potential for cooperation is repeatedly undermined by major political differences, not only *between* China and the EU but also *within* China and *within* the EU, some of which are unlikely to disappear in the foreseeable future. At least three types of political differences that constitute major obstructions to EU–China economic cooperation will be illustrated in the course of this narrative.

The most obvious example is provided by the different political assumptions that underlie economic policy in the EU and in China. Differences of view regarding the role of competition in the market, or the place of the state and the private sector in the economy, complicate discussion of economic relations between the People's Republic of China and any developed economy. The dominant position of state-owned enterprises (SOEs) in China, for example, affects the structure of the market, its efficiency and prospects for future growth, as well as the space available for non-Chinese competitors. China's determination to develop indigenous industrial sectors and technologies capable of competing internationally leads it to overlook or bypass the normal rules of the game. More fundamentally, the Chinese Communist Party (CCP)'s restrictive approach to property rights, open access to information, and the rule of law, all fundamental tenets of economic governance in the West, generate uncertainties and lack of trust that inhibit cooperation over the long term. The analysis in the following chapters will show how economic reform in China aims to address some of these problems, but fundamental differences of opinion persist in China over the choice of a market-driven or a state-driven economic model. Nationalism remains a powerful force, given new vigour by President Xi's "Chinese Dream."[2] Economic reform has so far been tentative and gradual. It has not yet reached a point where economic cooperation with China can be approached in anything like the same way as with other partners.

Differences in the political leverage exercised by a sovereign state like China and an association of sovereign states like the EU accentuate the difficulties arising from different political assumptions. The EU treaties confer a political role on the Union, including responsibility for the management of key aspects of the external economic relations of its Member States, such as trade and investment, but, as later chapters will show, the Union has considerable difficulty in exercising its mandate. The complicated division of competences between the Union and the Member States, combined with disagreements between Member States on some economic fundamentals, often means that it cannot formulate and deliver a coherent external economic policy, particularly towards a partner as large, strong, and fast-changing as China. Some of its biggest Member States do not always accept that their interests are best served by collective external action. Meanwhile, China has shown its willingness to deal with individual EU Member States or groups of them where it can, whilst repeating its commitment to closer relations with the EU as a whole. This tension between centralised and decentralised decision-making affects China as well as the EU: one of the more difficult political issues in China's economic reform is that of greater fiscal autonomy for China's provincial governments. The capacity of both China and the EU to manage the balance between centralised and decentralised power, albeit from very different starting points, will be an important factor in shaping future EU–China economic relations.

A third example of political difference affecting EU–China economic relations is the debate within the EU over the nature of the EU's common external policy: should it be values-based or interest-based?[3] Advocates of a values-based approach maintain that the EU's foreign policy cannot separate economic goals related to trade, investment, or other forms of international cooperation from the promotion of European values, such as the protection of human rights, democratic freedom of expression, and the rule of law. Such a values-based approach would stand in the way of closer EU–China economic relations as long as China does not undertake fundamental political reform, which the present Chinese leadership is not contemplating. Many in the EU, however, advocate a more interest-based policy, in which economic interests are to be pursued with international partners separately from and (by implication) without conditionality in terms of acceptance of European values by the EU's international partners. China presents this choice of approach for the EU in its most acute form, and it will be central to, for example, future discussion by the European Parliament of proposals to conclude agreements between the EU and China on investment or on free trade.

Why Another Book on China?

Academic literature on EU–China economic relations is fairly abundant, if much less so than analysis of USA-China relations. Many of the works take the form of journal articles or edited volumes that focus on specific features of the relationship, such as trade or investment or environmental policies, whilst some have included a combination of issues aimed at a particular audience. A recent example of this type is a wide-ranging guide to EU–China relations for European businessmen and potential investors produced by participants in the European Commission's Europe-China Research and Advisory Network (ECRAN).[4] The authors recognise their debt to the work already done by many others in this field of scholarship.

However, this book is different and offers three distinctive characteristics. First, the chapters presented here deliver an analysis of each of the main components of the EU–China economic relationship within a single framework, which takes into account a new background of changing economic fortunes in the EU and China. Such an integrated examination can help to identify recurring common features in the relationship across different sectors and allow cross-cutting conclusions to be drawn about its nature and direction.

A second distinguishing feature of this analysis is that it takes account of the economic and political environment emerging from the post-2008 economic and financial crisis. Attitudes to China across the EU have changed as a result of the economic crisis. China's continuing economic growth, in spite of the post-2008 recession in other parts of the world, has helped China become the second most important market for European exports after the USA, and its growing activity as an overseas direct investor has led to its being solicited by heavily indebted EU Member States as a long-term investment partner. Meanwhile, because of the effects of the recession on China's export markets, the Chinese leadership has recognised that economic reform, aimed inter alia at changing the China's economic model from an export-dependent to a domestic consumption-dependent one, is becoming urgent. Economic reform could transform the prospects for EU–China economic relations, but the evidence since the CCP's Third Plenum meeting in 2013 suggests that progress towards reform will be gradual and uneven. The incorporation into this volume of analysis of issues such as environmental sustainability and monetary policy, for example, will also help to illustrate the political dilemmas that economic reform in China brings with it.

The third main justification of this book is the specific situation of the EU. Its institutional arrangements imply a unity in its external economic policy that is often contradicted by the behaviour of its Member States. This issue deserves detailed analysis, especially in relation to an emerging power as important as China. The need to work out a new form of relationship with such a challenging economic partner is proving to be yet another stress test of the Union's capacity to act as one. The evidence so far suggests that the EU may not pass this test in all areas of EU competence.

The book that follows is conceived as an analysis useful for university faculty and students interested in China and the EU, as well as for the general reader, who may have a professional interest in economic relations between Europe and China as a businessman, civil servant, campaigner or politician, or who may simply be aware that China counts for something in today's world and is curious to know what that means for the future of Europe. The goal of this work is to provide an empirically-led examination that is academically informed but approachable for a wide readership.

Sources used for this book have been varied. The book's distinguishing feature is the incorporation of primary source interviews with a number of EU and Chinese officials involved in negotiations or consultations, as well as a number of political figures on the EU side. Published sources include meeting minutes and seminar records from EU and Chinese organisations (e.g., EU–China dialogue groups or the Chinese Academy of Social Sciences [CASS] Institute of European Studies [IES]), official papers, research think-tank reports, conferences, and seminars participated in by the authors, as well as current scholarship from journal articles and books. Statistics have been sourced from international organisations (International Monetary Fund [IMF], World Bank, United Nations Conference on Trade and Development [UNCTAD], and Organisation for Economic Cooperation and Development [OECD]), Eurostat, and official Chinese sources. The breadth and depth of these references are intended not only to support the arguments offered in each chapter but also to provide the interested reader with further avenues of exploration on each of the topics covered by this book.

Outline of Chapter Structure

The book is divided into three parts.

Part I, *EU–China Relations in a Global Context*, sets the scene for the analysis of particular areas of economic activity in Part II. Beyond the present chapter, which explores the political issues that underlie the economic relationship, two further chapters examine the overall context of EU–China bilateral economic relations and the international institutional framework in which the two sides operate and cooperate.

Chapter 2, *The EU's Growing Links with China's Reforming Economy*, introduces China's extraordinary economic re-emergence over the past four decades, the development of EU–China political and economic relations, and how that has contributed to both economies. Themes developed include the importance of EU–China trade and investment for both sides, China's contribution to improving EU industrial competitiveness, employment and living standards, and the importance of China as an export market. An assessment will also be made of the EU's economic importance for China as an export market and a source of inward investment, technology, and ideas.

The analysis also shows how, despite its dynamism, the EU–China economic relationship remains under-developed, taking as examples the large and persistent imbalance in two-way trade and its causes, the weakness of investment links, the limited role of China in the international monetary system, and lack of cooperation in industrial innovation and research. A comparison with the relations that the EU enjoys with other developed or emerging economies will illustrate these shortcomings and point to differences between the EU and China in terms of openness.

Chapter 3, *The EU and China in the Governance of Global Financial and Trading Systems*, analyses the latest developments in the institutional framework for international economic relations and the roles played by China and the EU within it. The chapter examines the concept of global governance and shows how China and the EU engage with each other in the domain of international economic, financial, and trade regulation, explaining why the global economic system is so important to this bilateral relationship and analysing why such interactions are becoming increasingly problematic at both bilateral and multilateral levels.

China's role as a re-emerging power is examined alongside that of the EU to show how different interests and priorities now exist between the two that are having a tangible impact on the evolution of global governance. The chapter argues that the longstanding US-led consensus on how the system should operate, who should be its leading decision-makers, and what should constitute norms of behaviour are coming under closer scrutiny and increasing strain. The argument concludes that, whilst some progress towards agreement is being made in the operation of particular sectors, such as in financial regulatory systems, in a number of other parts of the current systemic framework deep discord between the EU and China persists.

Part II, *Opportunities and Risks in the EU–China Relationship*, examines five areas of the EU–China economic relationship in turn: trade, investment, innovation and research cooperation, monetary affairs, and cooperation on common economic challenges (in particular, concerning the environment, climate change, energy policy, and urbanisation). Each chapter analyses the policy goals of China and the EU, examines current points of tension or shortcomings in the relationship, and assesses the likelihood of policy changes to address these problems.

Chapter 4, *Trade*, examines the changing character of EU–China trade and focuses on specific areas of trade conflict, in order to identify their underlying causes and assess whether the importance of EU–China trade is on an upward or downward trajectory. For the EU, the main problem is what might be termed as asymmetric reciprocity in the bilateral trading relationship with China—in other words, a one-sidedness whereby, whilst Europeans present what is strongly defended as an open single market, the Chinese maintain barriers to market access in some sectors, compete unfairly both in the EU and international markets because of subsidies or dumping, and restrict exports of raw materials. China, by contrast, focuses on EU reluctance to recognise China as a market economy under World Trade Organisation (WTO) trade defence rules, its maintenance of an embargo on arms exports to China, and the potential damage to Chinese interests arising from a mooted Transatlantic Trade and Investment Partnership (TTIP) between the EU and the USA.

The analysis assesses the real as opposed to perceived impacts of existing barriers, the kinds of policy change being sought by the aggrieved party and the political difficulties that any change would present to the other party. The chapter concludes that EU–China trade seems likely to continue to develop, albeit at a slower pace than hitherto, but suggests that the changing competitive position of China (facing rising labour costs, difficulties in innovating and increasing competition within Asia) alongside growing vigilance of the EU regarding subsidies and appropriation of intellectual property in new technologies, may lead to more rather than less conflict in future.

Chapter 5, *Investment*, explores how two-way EU–China direct investment flows are growing but remain far below what would normally be expected between such large economies. EU investment in China is constrained by legal exclusions in many economic sectors, restrictive conditions where investment is permitted, and fears of forced technology transfer and unreliable intellectual property protection. Chinese investment in the EU, on the other hand, is growing quickly from a low base and is generally welcome, although there is concern amongst Member States about the political risks of investment in strategic sectors, albeit with some disagreement about what constitutes a strategic sector.

The chapter assesses the prospects for the negotiations under way between the EU and China for a bilateral investment treaty (BIT). Such an agreement will only be reached if vested interests and political sensitivities about national security on both sides can be overcome. The EU will, for example, have to agree on a common approach towards Chinese direct investment in Europe—an area in which competition between Member States is fierce and policy differences between them are pronounced. China will need to review its policy of protection of SOEs in key economic sectors, including health, public utilities, and financial services. The analysis examines the policy areas in which resistance to change on each side may inhibit possibilities to reach a substantive agreement, concluding that significant differences and formidable difficulties remain.

Chapter 6, *Innovation and Research*, examines areas of contrasting yet complementary abilities between China and the EU, presenting evidence to show that China enjoys competitive success in incremental innovation but is relatively weak in key aspects such as basic research and the commercialisation of disruptive innovation, when compared to advanced industrialised economies such as the EU. China and the EU are each investing heavily in research and innovation as key inputs needed to make both of them more productive, and, superficially, this might indicate each side having shared interests and compatible talents. Yet persistent political obstacles to closer partnership are shown to be inhibiting the trust-building necessary for future success.

Whilst recognising genuine achievements at the level of some individual projects, the ambition for further progress is assessed against the apparent failure to realise more extensive structural cooperation because of inhibitors on both sides. On the Chinese side, these are shown to include weakness in intellectual property protection enforcement, preferential government procurement that favours domestic Chinese firms, and compulsory technology transfer rules. On the European side, inhibitors include policy fragmentation that undermines pan-European coherence, coupled to Member State zero-sum mentalities regarding engagement with China at the same time as the European Commission is seeking to agree priority pathways with China. The chapter concludes that unless such obstacles can be overcome it will difficult to realise the potential for cooperation.

Chapter 7, *Monetary Affairs*, examines the current international position of the euro and the renminbi (RMB) and assesses how policy changes under way in this area may affect the broader economic relationship between the EU and China. Whilst the Eurozone countries and China both have an interest in promoting greater international monetary stability and consult regularly on monetary affairs, each faces political challenges at home in seeking to strengthen the international acceptability of their currency.

The RMB is rapidly becoming one of the world's most traded currencies and from October 2016 will become a component of the Special Drawing Right (SDR), an international monetary unit managed by the IMF, but as long as it is not fully convertible, then China's position in international monetary affairs will remain significantly less influential than its economic weight would warrant. China has announced a long-term plan to achieve convertibility and has begun to liberalise parts of its financial markets. The political risks of such reform, however, are very great: allowing a competitive market to develop in China, and liberalising domestic interest rates, would effectively remove Party control of the banking system and the capacity to direct bank lending and increase volatility of the exchange rate. The euro, too, has a credibility problem. The political choices behind the Eurozone's banking union and common economic policy affect growth and jobs: Differences between Eurozone members on how to achieve those goals are deeply entrenched and unlikely to be resolved soon, and they are already affecting the euro's standing as an international currency. The chapter concludes with an assessment of the repercussions that greater integration of the China's currency into the international monetary system will have for the EU as a whole.

Chapter 8, *Cooperation on Common Economic Challenges*, examines cooperation between China and the EU in policy areas addressing common economic challenges, such as environmental sustainability and energy efficiency. The work programmes of four policy dialogues between EU and Chinese officials (environmental policy, climate change, energy policy, and urbanisation) are assessed in terms of their capacity to deliver knowledge transfer and business-level economic cooperation between EU and Chinese partners or to influence the policy of either side. Some of the political obstacles to cooperation referred to earlier are found here: reluctance on the Chinese side to extend cooperation to joint business ventures in China, a lack of reciprocity in information flows, and, in some areas, competition between EU-level and Member State cooperation with China.