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For a More Robust Approach Towards China in European Trade and Investment Policy

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New systemic and economic competition

China is no longer only a partner, but increasingly also a systemic competitor, due to the continued enforcement of state capitalism under Xi Jinping. The hope for change through trade has not been fulfilled, as the growing influence of the Chinese Communist Party shows. Trust in the Chinese leadership has been eroded in recent years due to an aggressive global raw materials strategy, expansive moves in Southeast Asia, the Belt and Road Initiative, the 17+1 initiative, and the interference with Hong Kong most recently.

For a long time, China was seen solely as a large and growing sales market, and a low-cost production location. This view certainly continues to be justified. However, in the meantime, Chinese companies have also become serious competitors. This raises the question over how much of the success enjoyed by Chinese competitors is based on distortions of competition.

If it was based on fair competition, it would be up to European companies and economic policy to address this challenge with more innovation, education, and supply-side reforms. It is true that China invests massively in education/research and can build partly on normal cost advantages and economies of scale.

However, the Chinese state also grants extensive subsidies for industrial policy purposes, thereby distorting competition. The system of subsidies is highly complex and opaque. It encompasses the intensive use of state-owned enterprises, a wide range of financial support measures (extended to private firms of strategic relevance), the subsidisation of production factors (capital, land, and low-skilled labour), and also of upstream inputs such as energy, raw materials, and metals. Finally, generous tax reliefs and export credits, as well as low social labour and environmental standards complete the picture. This industrial policy approach tends to create large overcapacity in China and on the global market (for example, in the steel sector or solar panel industry), depressing world prices and threatening to displace efficient European companies. OECD research of the aluminium sector and the semiconductor sector shows that Chinese companies are much more subsidised than their competitors from Europe or other industrialised countries.

Welfare losses for the EU?!

These negative spillovers onto the world market are increasingly problematic, because of the immense and growing size of the Chinese economy. Moreover, state intervention is not diminishing, but increasing under Xi Jinping. In addition, China is rapidly catching up in terms of technology - partly because of a forced technology transfer strategy. With its "Made in China 2025" plan, China aims to also catch up in sectors in which many European firms are specialised today. This strategy is also supported by massive state aid and incentives for Western firms to transfer technology, or even to invest in high-end research facilities in China.

In the medium term, the combination of these developments could endanger Europe's prosperity. In fact, it can be shown in relevant theoretical trade models that a rapid technological catch-up of China can lead to welfare losses in industrial countries. On closer inspection, the model assumptions do not appear overly unrealistic.

More robust approach towards China needed

It should therefore be the aim of the EU to strengthen Beijing's willingness to engage in a cooperative partnership and thus to reduce Chinese distortions of competition.

The ideal way to achieve this is through multilateral negotiations in the World Trade Organization (WTO). In fact, the EU, together with the US and Japan, has made far-reaching proposals for reforms of the WTO rules on industrial subsidies, as part of a trilateral initiative. To support this motion, the EU should try even harder to find coalition partners. However, the necessary Chinese agreement to constructive negotiations in the WTO on the containment of industrial subsidies is not on the horizon.

In parallel, the EU is negotiating a bilateral EU-China Comprehensive Agreement on Investment (CAI). Brussels is primarily focusing on improving the hitherto limited market access for European firms in China (reciprocity), and, more recently, on competitive distortions. It is true that China has improved access to its market to some degree, e.g., with a new investment law in 2020 (probably also as a result of the trade conflict with the US). However, the law’s stipulations remain vague. This and the lack of an independent judiciary put their enforceability into question.

Moving forward, the EU should heed several recommendations for the CAI negotiations:

- **The prioritisation should be reversed,** as competitive distortions are a much more serious problem, and as more reciprocity will be difficult to enforce legally in China.
- **Precautions to withdraw EU concessions** are needed in case China does not abide by a possible agreement in practice. This is relevant as the EU will severely limit its political leverage with the CAI when it binds its existing openness.
- **Substance needs to prevail over speed**. Brussels should not set any deadlines – like it did with the (now postponed) Leipzig summit, as this would make the EU a demander, thus weakening its negotiating position. The European negotiators have to insist on sufficient Chinese concessions, which need to be asymmetric, as the EU market is much more open and much less distorted by state interventions.

However, China’s overall concessions in the CAI have so far fallen short of the EU's expectations. Apparently, Beijing will not move sufficiently on the issue of competitive distortions without more negotiation pressure.

The EU should therefore choose a more robust approach and align even more with the US in this respect. More concretely, Brussels also needs to take unilateral action - in order to increase China’s incentives to engage, but also to prepare for a further increase in the global spillover of Chinese competitive distortions. However, in contrast to the US approach, European unilateral actions have to remain within the remit of WTO rules.

Not protectionism, but fair competition!

The framing of such an approach is crucial: China should be encouraged to cooperate sufficiently. However, if this does not come about, using defence instruments against competitive distortions must not be seen as protectionism, as usually portrayed by China and others, but as an attempt to level the playing field and to ensure fair competitive conditions.

The EU has various options to level the playing field. These include **more WTO complaints** against Chinese industrial subsidies and market distortions, greater use of the EU’s existing trade defence instruments (TDIs), and expanding the toolbox of similar instruments.

With regard to an **increased use of existing TDIs**, the EU uses anti-dumping and, above all, anti-subsidy measures, with a decreasing tendency over time, and significantly less frequently and with lower tariffs than the US. This is partly due to the fact that the EU, in its traditionally liberal mind, does not fully exploit the WTO’s legal scope for action. Therefore, the EU needs to act more proactively. It must be prevented that TDIs are only used when European companies are already seriously weakened by Chinese competitive distortions, as was the case with solar panels.

More concretely, the EU should better monitor market developments, simplify procedural TDI rules further, and strengthen its technical support efforts for Small and medium-sized enterprises (SMEs). Moreover, Brussels should consider self-initiating more TDI procedures and further relaxing the so-called lower duty rule, to be able to impose higher TDI-tariffs if required.

With regard to an **expansion of the trade and investment policy toolbox**, the EU should not only develop new defence instruments, but should also openly communicate this stance to further increase the pressure on China to negotiate. Important new instruments include:

- The **International Procurement Instrument** (IPI), as proposed by the Commission, would reduce access to EU public procurement for third countries with closed procurement markets, such as China. The objective is to increase the EU's leverage to open up other markets. The Council should adopt the IPI (with some minor changes to strengthen possible sanctions and to reduce red tape) by the end of 2020, if progress in the CAI remains elusive.

- A **Level Playing Field Instrument (LPFI) for the EU market** is needed to fill a regulatory gap. Currently, there is no way to tackle the problem that subsidised Chinese companies operating in the Single Market with artificially low prices threaten to force efficient European firms out of business. The Commission's White Paper on levelling the playing field regarding foreign subsidies clearly points into the right direction by proposing new competition tools. This initiative should be taken up soon by the European Council and Parliament.

- **Increased scrutiny of Chinese takeovers** of EU firms, in order to prevent an outflow of sensitive technological know-how. The new EU regulation on Foreign Direct Investment (FDI) screening rightly allows for greater possibilities of exemption from the principle of free movement of capital for third countries. This new tool needs to be urgently implemented by Member States. That should be done in a responsible fashion avoiding excessive bureaucracy and ensuring legal certainty.

With this more robust approach, the EU should signal to China that patience is running out. The question is, however, whether the EU (along with the US) can induce China to be more cooperative by containing distortions of competition, or whether China will force other players to be less cooperative as well. The future of the multilateral trading system likely depends on the answer to this question.

Drawback of the new approach: more trade-offs

A more robust stance towards China undoubtedly also has economic disadvantages for the EU: For example, more TDIs and the IPI would increase prices for users of the affected goods. Closer scrutiny of Chinese takeovers would create more bureaucracy, could deter investors, and property rights would be restricted if bans were imposed. In addition, there is a risk of protectionist abuse of the new tools, which must be counteracted with cleverly designed instruments. Furthermore, retaliatory measures by China can be expected.

This is especially the case in the discussion about the participation of Huawei in setting up 5G networks in Europe. For example, in 2019 the Chinese ambassador in Berlin vaguely talked about possible problems for German car manufacturers' sales in China in the event of a ban of Huawei. Similar threats were heard in other European capitals. However, alongside the United States and the United Kingdom, France and some other European countries have taken steps to limit Huawei's access, or even ban the firm from their networks. This step serves as a prevention of espionage or sabotage, particularly if geopolitical relations with China seriously deteriorated in the future. In comparison, the German government is more hesitant, even though there are controversial discussions in Berlin between important members of the coalition in the German Bundestag and the Chancellery.

Too dependent on China?

In respect to retaliation threats, the question arises whether the European economy is already too dependent on China and thus too vulnerable, which would restrict policy options. Looking at Germany, as the most exposed EU country on the export side to China, the dependency appears to be rather high at first glance. This seems to be substantiated by high turnover shares of 20 percent or more of their global sales for some large German companies in China.

However, this view has to be qualified.

- First, a large part of their Chinese sales come from local production, and benefits China much more than Europe.

- Second, there is an important difference to the German economy as a whole, because German exports are broadly diversified. In fact, German value-added exports to China account for only around 3 percent of Germany's total economic value added.

- Third, the share of German jobs that depend directly and indirectly on these value-added exports to China was only around 2.3 percent in 2015, according to OECD data.

Although these shares are relatively high by international comparison, a solid 97 percent of German value-added and jobs continue to depend on sources other than China. This puts the discussion about an alleged excessive dependence into perspective.

Three guiding principles for dealing with China

However, a world with continuing competitive distortions by China and with more European defence measures will become more complicated because difficult trade-offs would have to be solved. European politicians will have to decide on a case-by-case basis whether or not to take economic defence measures against China. To guide these decisions, three important principles are recommended:

- **Producer interests should be prioritised** in economic defence decisions. While there might be only a few severely affected producers, defence measures tend to increase the costs for a very large number of users of the respective goods in Europe, among them also large businesses, whose competitiveness will suffer. Policymakers might tend to focus on the interests of this large and influential majority. However, the impact on the costs and on the competitiveness of users is likely to be only small. In contrast, the threat to businesses affected by Chinese distortions might be existential. In this case, policymakers should side with producers to secure production and jobs in Europe. There can be no right for users to obtain goods at artificially low prices due to distorting subsidies or other non-market practices, if a relevant number of European jobs are at stake.

- **Long term orientation** is needed: However, short-termism tends to dominate in Europe. This is the case in policymaking due to election cycles and regular opinion polls, as well as in corporations, in view of the need to produce positive news for the next quarterly report. In contrast, China's government is acting strategically and over the long term, as the MIC25 strategy indicates, among others. Due to European short-termism, safeguarding the future can fall by the wayside if the measures required for this purpose incur high costs in the short term. For example, the prohibition of Huawei from participating in 5G networks, while rendering them more secure in the long term, will make their build-up (somewhat) longer and more costly in the coming years. By way of another example, the focus on short term profits in China tends to entice corporations to transfer important parts of their technology, despite this having a negative impact on the company in the longer term, due to increasing Chinese competition.

- **Safeguarding European production and jobs,** particularly of SMEs, should be the primary objective compared to the interests of European corporations with production operations in China. As a rule, the interests of both sides are in line - but not in all cases. For example, in the CAI, negotiating market access in China is prioritised (to the benefit of large corporations that produce increasingly in China), instead of focusing mainly on Chinese competitive distortions, which increasingly threaten to jeopardise jobs, particularly in SMEs in Europe. Moreover, if China increasingly subsidises European corporations that re-export from China to Europe, a direct conflict of interests could arise.

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