Trading With China: Win-Win Or Zero Sum Game?

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A casual reader of the European and American media might be forgiven for thinking that many people see the West losing out to China over trade. It is understandable that many, including of course those who have lost their jobs to China, see a rising trade deficit (EU €169 billion and US $268 billion in 2008) and draw this conclusion. But this is only part of the story.

This article explains the current situation, reviews the trade relationship trade frictions, addresses the issue of market economy status (MES) and looks to the future.

First, some facts:

- China is the world's fourth economy.
- China is the third biggest exporter.
- China is the EU's second largest trading partner.
- The EU is China's largest trade partner.
- China is the biggest importer to the EU.
- China is the EU's fourth largest export market
- EU goods exports to China in 2008 amounted to €78.4 billion.
- EU goods imports from China in 2008 amounted to €247.6 billion.
- The EU trading deficit with China in 2008 was €169.2 billion.
- EU services exports to China in 2008: amounted to €20.1 billion.
- EU services imports from China in 2008 amounted to €14.4 billion.
- EU inward investment to China in 2008 amounted to €4.5 billion (€7 billion in 2007).
- China inward investment to the EU in 2008 amounted to €0.1 billion.

The figures are taken from EU official statistics

Current situation

The EU's open market has been a large contributor to China's export-led growth. The EU has also benefited from the growth of the Chinese market and the EU is committed to open trading relations with China. However it pushes China hard to trade fairly, respect intellectual property rights (IPRs) and meet its WTO obligations.

EU's imports from China are mainly low value-added and low technology goods. EU's exports to China are mainly high value-added and high technology goods. However, China is moving up the value chain, which will increase competition. Southern and Central European low value-added manufacturers are suffering badly from Chinese imports.

There is deep concern over the EU's growing trade deficit (nearly €170 billion in 2008). However, the extent to which it is a China-specific deficit or an overall deficit with lower cost producing countries is arguable. Put another way, if the EU reduced imports from China, would they be replaced by imports from another – probably Asian – country?

World Trade Organisation and market access

The formal accession of China to the WTO in December 2001 was strongly supported by the EU. Chinese commitments improved access for EU companies to the Chinese market. Import tariffs and non-tariff barriers were substantially and permanently reduced.

China has made good progress in implementing its WTO commitments, but there are still many problems, in particular industrial policies which discriminate against foreign companies in the automobile sector. There is inadequate protection of IPRs, and obstacles to market access in a number of services sectors including banking, construction, express postal services and telecommunications. Access to raw materials is also regarded as a serious trade barrier.

The European market is very open to imports from China. The Chinese are concerned that European protectionism is on the increase. However, "Buy local" provisions in rescue packages during the financial and economic crisis have been resisted. Strict rules are applied to any state aid for industries, ensuring that they are targeted, specific and temporary. The EU market has been kept open, with neither tariffs being raised nor quotas lowered.

There is insufficient trade reciprocity - the legal and administrative restrictions on European companies trading and investing in China are far greater than those Chinese companies face in Europe. This feeling is confirmed by the European Union Chamber of Commerce's *"European Business in China Position Paper 2009/2010"* which was published in September 2009.

European businesses have observed a slowdown in the pace of reforms over the past 12 months, with some sectors reporting that the situation has actually worsened as industrial policy interventions and foreign investment restrictions have increased.

Trade frictions

There will always be trade disputes, and the more the trade, the more the disputes. It is vital to avoid their affecting the political relationship. There are always major transatlantic trade disputes (eg Airbus vs Boeing) but they do not affect the non-trade EU-US relationship. This having been said, there may be a spill-over if the trade deficit is not reduced, and this can only be done by increased access to the Chinese market.

Linked to trade tensions is the question of the value of the renminbi. This has always been more an American concern but, with the Chinese currency pegged to the dollar, the euro has substantially strengthened against the renmimbi, thus increasing the trade deficit and making European companies less competitive in China compared with US companies.

Manufacturing in China is helped by an undervalued exchange rate, access to cheap credit, cheap land and to other subsidized inputs and the non-enforcement of environmental and labour standards. There is a danger that trade frictions will cause international companies to reconsider their dependence on China, and diversify their factory investments and sourcing.

Beijing complains that recent anti-dumping measures are driven by protectionism. The Union carried out, in the first half of this year, two anti-dumping investigations and imposed three anti-dumping measures against imports from China. Ant-dumping duties of 24.2% were imposed on Chinese steel rods in July.

It is important to bear in mind that Chinese exports subject to EU anti-dumping duties or currently under investigation, affect less than 1%

of imports from China. China acts in a similar manner and has also filed a complaint with the WTO over EU anti-dumping duties and threatened to take retaliatory measures.

However, this does not mean that the EU will adjust its trade policies, because protectionism is against the interests of Europe, being the world's largest trading block. But, in the light of the ongoing global economic recession, there is a risk that political leaders will succumb to calls for protectionism by their electorates.

The biggest danger for China comes from the US, in the light of the special interest lobbies and the fact that Democrat sentiments are more protectionist than those of the Republican party.

This can be seen, for example, in the "Buy American" provisions of the $787bn stimulus package. The perception is that China has followed suit with its joint statement in May by nine ministries and government agencies, led by the National Development and Reform Commission (NDRC), that government investment projects should purchase domestic products.

It is believed in the US that the recent WTO Panel ruling on publications and audiovisual products will help open up the Chinese market for everything from magazines, CDs and DVDs, music downloads and books, to film blockbusters, as well as curbing intellectual piracy. It could also set a precedent for others, such as automakers claiming to be hampered by cumbersome Chinese distribution rules. China has appealed against the ruling.

The US has imposed a tariff on China-made tyres - a victory for the complainant, the United Steelworkers Union, over tyre importers and some US tyre manufacturers with plants overseas. However, it does not follow that overall imports will be less as there are other cheaper sources. Even more recently, the US has imposed duties on steel pipes imported from China.

Beijing reacted immediately and opened an investigation into whether car parts and poultry from the US are being unfairly dumped on the Chinese market. A complaint has been lodged with the WTO to have the US tariffs declared illegal. China is also considering possibility imposing countervailing duties on subsidized US goods, the auto industry having been hugely bailed out. There is a history of disagreement over auto products and chickens.

While a China-US trade war is not expected, the deteriorating climate may bring extra protectionist pressure on President Obama. The number of "safeguard" measures brought against China in the first seven months of this year (16 according to the WTO) is worrying. This is an insidious measure not requiring proof of unfair pricing.

Foreign direct investment

EU direct investment has fallen, partly due to the economic and financial crisis and partly due to difficulty in merging with and acquiring Chinese companies. Chinese direct investment in the EU is negligible.

High Level Economic and Trade Dialogue

A new strategic mechanism for driving trade and economic policy -the High Level Economic and Trade Dialogue (HED) - was launched in Beijing in April 2008, under the chairmanship of Chinese Vice-Premier Wang Qishan and of the then EU Trade Commissioner Peter Mandelson, as representatives of Premier Wen Jiabao and of European Commission President José Manuel Barroso.

It is intended to strengthen the dialogue between the European Commission and the State Council of China. It deals with issues of strategic importance to EU-China trade and economic relations and is intended to provide impetus to progress in sectoral dialogues. This dialogue allows issues of mutual concern to be addressed. The second HED took place in May 2009 in Brussels, under the chairmanship of Wang Qishan and of the then EU Trade Commissioner, Catherine Ashton.

According to Vice-Premier Wang Qishan, the HED must be "strategic, forward-looking and plan-setting". The HED should not itself address specific issues arising from a large, complex trade and investment relationship, but should ensure that solid results are achieved that reduce the trade deficit and trade tensions.

The EU and China have a large number of bilateral dialogues and mechanisms at working, senior officials, and ministerial level. The HED is not supposed to replace them, but ensure that they operate coherently and give them the necessary political drive when required.

Trade deficit

China had a trade deficit with the EU until 1997. Although the EU is China's largest export market, China is only the EU's fourth (after the US, Switzerland and Russia).

European and Chinese leaders have long been aware of the delicacy of the issue of the trade deficit, and how potentially destabilising it could be for the strategic economic relationship between Europe and China.

The 2007 EU-China Summit declared – at the initiative of Premier Wen Jiabao – that trade imbalances between China and Europe were not sustainable and had to be addressed in a more strategic fashion.

Current needs

Europe seeks a stable, predictable and transparent regulatory framework; a clear, stable, non-discriminatory investment environment; and effective protection of IPRs. China seeks a curb on anti-dumping actions by receiving market economy status, the avoidance of protectionist measures and the unrestricted right to invest in the EU.

Partnership and Cooperation Agreement

The two polities are laboriously negotiating a Partnership and Cooperation Agreement. The Commission wants a single agreement, incorporating the updating of the 1985 EC-China Trade and Economic Cooperation Agreement. Beijing seeks two separate agreements, the likely outcome, as little progress has been made in the trade negotiations.

Market Economy Status (MES)

The EU, and western companies working in China, insist that there is far from a level playing field in goods and worse still in services.

The obstacles are legal, bureaucratic and practical. Early progress on granting MES is not anticipated. Beijing, however, considers the EU policy to be very unfair. MES will automatically be granted in 2015-16 under WTO rules.

The EU requires four technical conditions to be fulfilled: ensuring equal treatment of all companies by reducing state interference; improving corporate governance; ensuring equal treatment of all companies in bankruptcy procedures and in respect of property and IPRs; and bringing the banking sector under market rules by removing discriminatory barriers. However, the decision is ultimately a political one.

The big advantage to China of the reclassification would be to curb the increasing number of anti-dumping actions. The granting of MES is regarded as one of the few cards the Union has to play in trade negotiations. The obvious quid pro quo is China making market access and investment concessions.

The EU should seek an early deal on MES for two reasons: if the EU does not negotiate soon it will be granted automatically in 2015-6, rendering negotiations useless. There is still an opportunity to wring some greater IPRs protection and market & investment access commitments out of Beijing.

The Chinese need to appreciate that a positive approach to the lifting of MES is in their interests, because of its effect on protectionist trends. The time is also opportune as Beijing has raised the same question with Washington. Agreement would also act as a stimulus to the overall relationship.

The EU should state specifically what concessions are required, proposing that, say, half of them be fulfilled before MES is granted.

Both IPR protection and better market access for services are in China's interests. The non-enforcement of IPR is an ongoing problem for European companies. China needs European technology but both for economic development and to achieve a low-carbon economy companies are hesitant to provide it as they run the risk of their IP being improperly exploited. The services sector is inefficient and Chinese companies would benefit from the provision of improved services.

Future

Is the Chinese development model sustainable? Let us first look at its main characteristics. It cannot be defined in simple terms, being in reality a process, its origins lying with Deng Xiaoping. Its key features are pragmatism, trial and error and gradual reform.

The model is not based on ideology but practical steps, first testing the effectiveness of policies and then, when proven, rapidly implementing. Labels do not satisfactorily describe the model, which the Chinese say is based on socialism with Chinese characteristics.

The model has number of key characteristics:

- The state controls the strategic direction of the economy and therefore its strategic sectors: state-owned enterprises still dominate industry.
- The government can thus set and direct its economic priorities.
- From the outset, foreign direct investment (FDI) was encouraged as was higher education abroad of young Chinese, particularly in science and technology.
- China has not hesitated to adopt foreign ideas and practices, such as entrepreneurship, international trade, the market, but has never allowed such foreign imports to interfere with government policies.
- Successive generations of leaders have been able to ensure continued public support for modernization and, at the same time, macroeconomic stability.
- The model has delivered several hundred million people out of poverty.
- Contrary to many Western beliefs, this model, despite its shortcomings, has been more effective than, say, the exported American model based on ideology and democratization, with scant attention to local circumstances.

But is the model sustainable? It now faces three major challenges: first, how to correct China's uneven development; second, how to cope with the unsustainability of export-led growth; and third, how to handle the value of the yuan. It was recognized in 2004 that too great an emphasis was being placed on GDP growth and a more "people-oriented" approach was needed. However, the difference in economic development since then has not been noticeable. The leadership continues to call for "scientific" or sustainable development. Climate change and environmental degradation are deep concerns.

Regarding the second challenge, China relies massively on exports to achieve its growth. The US trade deficit has continued to rise, as does the Chinese currency reserves. Thus, China is lending the US money to buy its exports. This situation is not sustainable and indeed is dangerous.

There is broad agreement that it is in China's own interests to promote consumer spending so as to produce domestic demand-led growth. But the huge incentive package is being spent mainly by state-owned enterprises and on infrastructure projects. While spending has increased, the Chinese remain big savers, so as to provide for their old age, healthcare and education of children.

Needless to say, the non-sustainability of Chinese development would give rise to serious domestic unrest. On the other hand, much greater regard must be had to the environmental dimension which will slow up growth. It is in everyone's interests that substantial economic growth is maintained.

Conclusion

The trade negotiations are not progressing at all satisfactorily. A serious attempt should be made to agree that the EU grants MES in return for effective measures to increase market access, reduce investment restrictions and increase IPR protection. ■