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China's Economic Relationship with the European Union

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1. Opening Comments

Members of the Committee, ladies and gentlemen, I would like to thank you for inviting me here today to talk about China's economic relations with the European Union and its implications for the United States and the wider international community. In recent times the European Union and China have talked increasingly of fostering a 'strategic partnership' between them, this being primarily founded on their strengthening economic ties. While the term 'strategic' may set off certain political alarm bells here in Washington, I do not believe the EU – China partnership is intended to directly challenge the US's position in the global economy or other domains. Rather, the main objective of this partnership is to build up a key linkage in international society that, amongst other things, should lead to more effectively addressing common global economic challenges that face us all.

2. China – Europe: Economic Exchange and Diplomacy

Economic Exchange

For some time, Europe was the 'Cinderella' trade partner to China, always lagging some way behind Japan and the United States. This, though, is no longer the case. In 2002, the EU was China's third most important trade partner but by 2004 Europe had become *the* most important according to statistics from China's Ministry of Commerce:

- *China's import trade*: In 2004, China imported $70 billion worth of goods from the European Union, this representing 12.5 percent of China's total imports. This compared to $45 billion of imports from the US (8.0 percent of total), and $94 billion from Japan, China's biggest single source of imports (16.0 percent of total).

- *China's export trade*: China's exports to the EU in 2004 meanwhile came to $107 billion (18.1 percent of the total), which was some way below the $125 billion worth of exports dispatched to the US that year (21.1 percent of total) but above the $74 billion figure for Japan (12.4 percent of total).

- *Total trade*: Putting these figures together, China – EU trade in 2004 totalled $177 billion, China – US trade a close second at $170 billion, and China – Japan trade an even closer third at $168 billion. While there is, then, not much difference here between China's main trade partners, its trade volume growth with Europe has been the fastest of the three, and most recent figures for the first quarter of 2005 suggest that the growth rate for EU – China trade is currently accelerating faster than for any other major trade partner, at approaching 25 to 30 percent per annum.

EU trade and China: Moreover, China is now the EU's second largest trade partner, the US still remaining the largest. In 1980, China accounted for only 0.7 percent of EU imports and 0.9 percent of EU exports. By 2004 these shares had risen to 12 percent and 5 percent respectively. The EU's trade with China has well over doubled over the last five years, making it Europe's most dynamic major trade partner by far.

Europe's investment position in China: European firms have also invested heavily in China with the accumulative total of foreign direct investment, or FDI, from the EU reaching $60 billion by 2003. This represented 21 percent of all inward FDI stock in China if FDI from Hong Kong and Taiwan is factored out, which compares to the US's 24 percent and Japan's 22 percent. While Europe remains in third place, its share has increased at a much faster rate: in 1996 the EU's share was 14 percent, the US's 22 percent and Japan's 17 percent.

China and the euro: In finance, China has recently showed a preference for euros over dollars in its expanding foreign exchange reserve portfolio, that at around $800 billion in total is the second largest in the world after Japan. This has further strengthened China's stake in the European Union economy.

Education and tourism: At the inter-societal level, increasing numbers of Chinese students are coming to study at Europe's schools, colleges and universities, especially to the UK, which attracts the second highest number of Chinese university students in the world after the United States. With rising incomes and high social value afforded to education, the EU can expect to see many more Chinese nationals attending European universities, although the preferred destination still remains the United States. This growth in human contact or 'socialisation' between EU and Chinese nationals provides an important micro-level underpinning the EU – China economic relations, as is similarly the case for US – China economic relations.

Economic Diplomacy

The substantive deepening of economic ties has been paralleled by an ever closer economic diplomacy between the EU and China. Trade and co-operation agreements were first signed in the late 1970s and mid-1980s. Although high-level economic diplomacy cooled in the aftermath of the 1989 Tiananmen Square massacre, it had advanced again by the mid-1990s, marked by the publication in 1995 of a European Commission policy document entitled *A Long-Term Policy for China-Europe Relations*. This outlined the EU's intent to move beyond its past approach of mainly trying to *contain* the competitive threats posed by China (for example, by using the blunt instrument of anti-dumping duties on various Chinese imports) to an approach that emphasised a broader economic and diplomatic *engagement*. A key element of this was to encourage and support China's integration into "international structures", such as the World Trade Organisation (WTO) and the multilateral trading system. The idea was, and remains, to deepen China's sense of international citizenship, which in theory should make it a more predictable and responsible member of the global community.

Subsequent European Commission policy papers further articulated this intended shift from containment to engagement, such as the 1998 *Building a Comprehensive Partnership with China* document, and more recently the 2003 document entitled *A Maturing Partnership: Shared Interests and Challenges in EU – China Relations*. These have helped define the interests and goals of the emerging strategic economic partnership between China and the EU, at least from Europe's perspective. At the December 2004 EU – China Summit, the two parties agreed to add new layers of economic co-operation between them by signing a raft of (albeit relatively low-funded) co-operation programmes, for example on managers exchange and training, information society, and research and development.

At the inter-regional level, the EU has worked together with China and other East Asian countries since 1996 within the Asia-Europe Meeting framework, or ASEM, which has sought to cultivate closer economic, political and socio-cultural ties between both regions. The major EU member states also meet with China at the G8 meetings, China being in effect an associate member of the Group. Diplomatic engagement between the EU and China at the global-multilateral level is also deepening, particularly after China's accession to the WTO in 2001. Taken together, these expanding points of diplomatic contact have provided new opportunities for the European Union and China to discuss economic and other matters, and further develop the basis of their strategic partnership.

3. Challenges and Contentious Issues

Thus far I have framed China – EU economic relations in positive terms of general growth and development. There are, of course, significant competitive challenges that China poses to the European Union economy. These are broadly similar to those that face the United States, as illustrated by recent textile trade disputes with China. The EU and China have come to a resolution on this particular issue but Washington and Beijing have yet to reach an agreement. In other areas, the EU still applies a number of anti-dumping duties on Chinese imports, for example on bicycles, and has expressed its concern over China's managed exchange rate regime, although not as vehemently or as persistently as the United States has done. While EU Trade Commissioner, Peter Mandelson, recently commented that China "must not stick to an artificially low exchange rate as part of a strategic trade policy, or fix prices below long-term sustainable costs", he also conceded that the European textiles industry "will need to adjust because, ultimately, our responsibility is to compete." [*International Herald Tribune*, 09.04.2005].

China's difficult regulatory environment and lax commercial laws continue to frustrate European, American and other foreign investing firms alike, although the Chinese are making some progress at improving the situation. Corruption levels, while still comparatively high by broad international standards, are reported to be falling significantly. The commercial legal environment is improving too, partly out of intensified competition between provincial governments to attract foreign investment ['Country Profile Report on China: 2004' *Economist Intelligence Unit*, 2005]. Both the European Union and the United States are encouraging China to accelerate the pace of economic reform. Further progress should be expected given that China is committed to further open up its economy and strengthen certain areas of commercial law under the terms of its WTO accession.

Overall, though, the European Union's problems with China's commerce are generally less acute and less complicated when compared to the US's own problems: *less acute* because the EU's trade deficit with China has always been around half of the US's own deficit with the country (in 2004, $37 billion compared to $80 billion respectively), and *less complicated* because the EU's economic relations with China are largely unencumbered by national security issues, an important matter for discussion which I shall return to in a moment.

The European Union is, though, still concerned about its trade imbalances with China and the negative impacts that highly competitive Chinese imports are having upon European industries. The European Commission, national European governments and Europe's business associations are assiduously examining these manifest impacts, and the EU may again apply 'transitional safeguard mechanisms' on Chinese imports other than textiles. The Committee will probably already know that, under the terms of China's WTO accession, these measures may be utilised where surges of Chinese imports are deemed to cause, or threaten to cause market disruption to other WTO members during a 12-year period from the date of accession. It is difficult to gauge the extent to which the European Union will react in a protectionist manner towards Chinese trade competition, but it is probably safe to say not to the same degree as is being contemplated here in the United States.

The EU is likely, however, to soon 'graduate' China from its Generalised System of Preferences (GSP) scheme – under which the EU grants autonomous trade preferences to imports from developing countries – on the grounds that the country's export profile has grown so strong. China is currently the main beneficiary of the European Union's GSP scheme with a share of more than 30 percent of all qualified preferential imports. Beijing is unlikely to object to GSP graduation given its burgeoning trade surplus with the EU.

4. China: Security Threat or Commercial Opportunity?

While, then, the EU is taking these competitive challenges and contentious issues seriously, the 'China threat' does not resonate in Europe in the same way that it does in the United States. Regarding matters of commerce, chief economists around Europe tend to see the dynamic Chinese economy more as an opportunity than a threat, but commerce is not the only part of the economic diplomacy equation. A key reason why Europe – China economic relations have prospered is that they not burdened with the same national security concerns as US – China economic relations appear to be. There have been no bids from Chinese companies to acquire perceived strategic commercial assets in Europe, as has recently been the case in the United States, such as Lenovo's acquisition of IBM's personal computer division and CNOOC's current attempts to acquire Unocal. More generally, the fact that the European Union has virtually no security responsibilities in East Asia allows Europe and China to cultivate their economic relationship unhindered by the security-related distractions and tensions that seem to beset the US – China economic relationship.

Although the European Union has at times sought to press Beijing on other sensitive matters like human rights and the rule of law, China is generally not seen as a potential enemy to Europe. This has helped the EU – China economic relationship advance in certain key areas over and above what is currently possible in US – China economic relations, as recently illustrated in the field of space technology collaboration. American and Chinese co-operation in this sector has effectively ended since the US tightened its regulations in 1998 on illegal missile technology transfers that subsequently led to the classification of space technology on the US State Department's munitions list. Meanwhile, Europe has significantly enhanced its space technology co-operation with China. Since October 2003, China has worked with the EU in developing Europe's *Galileo* satellite navigation system, an emerging rival to the US's own Global Positioning System, or GPS. Many other avenues of high-tech co-operation between the US and China are most likely closed off due to various security-sensitive restrictions, yet China and Europe do not generally face such constraints.

China's economic relations with the European Union also appear less encumbered by ideology than are US – China relations. Professor Feng Zhong-ping, Director of European Studies at China's Institute of Contemporary International Relations in Beijing, recently commented that, "a lot of European countries want to support and encourage China's development, while the Americans want to influence the direction of its development" [*Wall Street Journal*, 13.06.2005]. American missionary zeal to convert China into a democratised, market-oriented society is far stronger than Europe's. There are complex social, political and historic reasons for this that relate perhaps more to the US's perceived role in the world than Europe's own less well-defined role. In sum, the EU has been both able and willing to take a pragmatic approach towards its economic relations with China, and this seems to have spurred their development as recent data on trade, investment and other economic indicators suggest.

It may also be instructive to cite the comments from China's Trade Minister, Bo Xi-lai, made after resolving his country's textiles trade dispute with the EU in June 2005. Bo stated that, "Unlike some other countries, the EU didn't take unilateral steps against China but discussed the issue in a friendly manner. The Chinese people have a saying: if you respect me by an inch, I'll respect you by a foot" [*Wall Street Journal*, 13.06.2005]. Whatever interpretation you take on this thinly veiled jab at the United States on this issue, it reveals how Beijing currently views its bilateral economic diplomacy with the US in more problematic terms in comparison to that with the European Union.

5. Common Economic Security and Global Interests

The EU and US's bilateral problems and contentious issues with China must be managed accordingly but equally so must economic partnership and co-operation with her be promoted. For both the European Union and United States, cultivating positive relations with big emerging developing countries like China will be of critical importance as this century unfolds. The EU, US and China all three face the same major global economic security challenges, such as energy and food security, poverty alleviation and moving towards a more eco-sustainable development paradigm. Effectively addressing these global economic issues requires the cultivation of positive and harmonious international economic relations at various levels.

In the WTO, China appears to be not just championing developing country interests in coalition with other emerging powers like India and Brazil, but also seeking to build bridges between developing and developed countries within the Doha Round of global trade talks. Some may argue such manoeuvres are intended to gradually strengthen China's structural power within multilateral organisations: that is to develop capabilities to shape the rules of the game by which all other nations must abide. However, the prevailing European view is that it is better bring China into various multilateral frameworks and work constructively alongside her rather than engage in confrontational stand-offs. Having said this, the European Union – or more specifically particular EU member states – need to make far greater concessions on agricultural trade liberalisation at this stage of the Doha Round if it is to build a more constructive partnership with China and developing country trade partners in general. The same too applies for the United States.

It is my view that the multilateral dimension to China, EU and US economic diplomacy will become of increasing importance over forthcoming years and decades. China's accession to the WTO has been a crucial step forward in deepening the country's sense of international citizenship and multilateral responsibility, in keeping with the aforementioned EU objective of integrating China into "international structures". In the past, China was wary of multilateral institutions and mechanisms, whether at a regional or global level. Many of the Chinese elite perceived multilateral economic organisations as more or less extensions of American foreign economic policy, or as essentially serving broader Western interests. However, a more positive view towards multilateralism has been in the ascendant amongst Beijing's policy-makers for a while now, mainly because it sees the WTO, IMF, World Bank and so on as the ultimate custodians of the international economic system in which China is flourishing. It is thus in China's own interests to support the development of these organisations, and work with others multilaterally to avert future systemic disturbances to the global economy on which the country increasingly depends.

I'm not going to speculate about the exact extent to which the Chinese worldview has shifted beyond Sino-centrism and its traditional belief in a hierarchical world order that has previously narrowed China's scope for multilateralist thinking. But China now exists, like other nations, in a very different globalising world and the Chinese are pragmatists. For a communist country to embark on a sustained programme of capitalist-based economic reforms over almost 30 years clearly shows this.

China knows full well that her rising power is based on economic growth, a growth that is significantly founded on international trade and investment. Moreover, the economic fortunes of China, Europe and the US are based on increasingly interdependent connections with each other and others. American and European consumers buy cost-efficient (and thereby inflation-resistant) produced goods from China – a high percentage of these being exported from US and EU firms based there – that in turn generates the surpluses for China to act as part creditor for the debt-laden United States and European Union economies. To date, China has purchased more than $230 billion worth of US government securities, and a substantial but un-estimated amount of European government debt (*Financial Times*, 18.07.2005). China, Europe and the US are *de facto* 'strategic partners' in today's global economy whether they like it or not, such has the degree of economic interdependence that now exists between them, and economic partners as globally significant as themselves need to work together, particularly at the multilateral level because this encompasses the wider international community. They must avoid a descent into the kind of confrontational relations that have in the past precipitated major conflicts between great powers.

I of course accept that China has become a significant economic competitor to the United States and European Union, and there are inherent risks and threats borne therein to the US and EU economies. By the same token, China's ascendancy has already provided considerable economic benefits to the US and EU, as previously noted, and the scope for cultivating economic relationships or partnerships with China is broadening all the time. As EU trade chief Peter Mandelson remarked earlier this year with respect to China, “We won’t be trading Airbuses for t-shirts for much longer”, and that, “competition and partnership can go hand in hand” [*International Herald Tribune*, 09.04.2005].

The US and EU’s shared past experience of addressing the ‘Japan threat’ from the 1980s showed that with a rising high-tech competitor also come greater opportunities for high-tech co-operation between firms from different regions. Moreover, on the highly geo-politicised issue of oil supply security, it is imperative for China, Europe and the US to work towards a mutual reduction of oil dependency, as well as promote multilateral co-operation on developing renewable energy technologies and achieving greater fuel efficiency. While this may sound idealistic, what is the alternative? Intensifying adversarial competition for natural resources that could lead to open military conflict? China, Europe and the US owe it to themselves and the rest of international society to find peaceful solutions to these common problems based on the mindset of co-operation, partnership and trust.

Thank you.