

## RECIPROCITY: THE NEW MANTRA OF THE EU'S TRADE STRATEGY TOWARDS CHINA

---

### Mario Esteban

*Senior Analyst, Elcano Royal Institute;  
Senior Lecturer, Autonomous University of Madrid  
mario.esteban@rielcano.org*

### Introduction

The European Union is at a critical juncture: besieged by Brexit, a poorly managed refugee crisis, the looming threat of Islamist terrorism, and the stagnation of living standards for European low and middle income classes. This last point is closely related with how useful the EU is in the eyes of its population for navigating an increasingly globalised world where the emerging countries, particularly China, play a bigger role in the international economy and global affairs.

China is a key economic partner for the European Union (EU). As EU Commissioner for Trade, Cecilia Malmström, has explained, the EU's commercial relationship with China has brought sizeable benefits for Europe, including over 3 million jobs that depend on sales to China, and increases in the competitive advantage of European companies with providers based in China (Malmström, 2016a: 1). China has communicated to the European Commission its desire to deepen this relationship through a free trade agreement (FTA), which would prevent protectionist movements in Europe and secure access to the common market.

A positive response by Brussels could have been expected, considering the above-mentioned beneficial effects of EU-China trade for the European economy, the boost in the purchasing capacity of European consumers, and the emphasis put on trade liberalisation by the European Commission. However, Brussels considers rebalancing the relationship to be a precondition for opening FTA negotiations.

The EU feels that the Chinese economy has reached a high enough level of development to make it unreasonable that Chinese companies enjoy much more beneficial terms in Europe than European companies do in China. Therefore, the new mantra in Brussels on EU-China relations is "reciprocity", assuring a more level playing field for European economic actors vis-à-vis their Chinese counterparts. Accordingly, the EU wants Beijing to implement further domestic reforms and to grant a more reciprocal treatment to European companies operating on its soil before exploring the possibility of negotiating an FTA. If Brexit is consummated,

the possibility of an EU-China FTA would move further away, since London has been one of the more vocal supporters among the EU member states for opening negotiations with Beijing on this issue.

This article is divided into five sections. First, the significance of EU-China trade relations is underlined. The second section presents the main obstacles hindering further liberalisation of EU-China trade. The guidelines of the new EU trade strategy are introduced in section three. Section four analyses the significance of the two most pressing issues for EU-China trade relations, the negotiation of a bilateral investment agreement (BIA) and the EU's decision on China's market economy status. Finally, some conclusions are offered.

## **EU-China trade relations matter**

According to the figures provided by the Directorate General for Trade of the European Commission, in 2015 the EU and China traded goods worth over €20 billion, making China the EU's second biggest trade partner (14.8% of the EU's total trade and 9.5% of its exports), after the United States (US). In addition, China has also become the EU's biggest source of imports (20.3%), enjoying a trade surplus with Europe of over €80 billion. This significant bilateral trade deficit in goods is only partially compensated by trade in services (€0.3 billion surplus in 2015). If we look at EU-China trade from the perspective of value added trade, the bilateral trade balance still tilts in Beijing's favour. According to the more recent data available at the Trade in Value Added Database, compiled by the Organization for Economic Cooperation and Development (OECD) and the World Trade Organization (WTO), China's (including Hong Kong) surplus of trade in value added with the EU is also quite significant, amounting to \$71.5 billion in 2011. The EU partly blames its huge trade deficit with China on remaining market access barriers imposed by Beijing. On the other side, Europe ranks as China's main supplier (13% of total Chinese imports) and the second biggest market for Chinese exports (15.6% of Chinese exports).

Besides, even if the EU does not want to pursue a geopolitically guided trade strategy towards Beijing, the signing of an EU-China FTA or BIA could have geostrategic repercussions in the context of growing US-China tensions. The Chinese authorities are quite aware of how those agreements could undermine Washington's further attempts at economic containment against China, such as were witnessed with the creation of the Trans-Pacific Partnership, a trade agreement in the Pacific which excludes China, or the lobby against the Asian Infrastructure Investment Bank (De Jonquières, 2016). This geostrategic rivalry between China and the US can give Europe some leverage in the ongoing negotiations for the Transatlantic Trade and Investment Partnership and the EU-China BIA.

## **EU trade strategy**

In October 2015 the European Commission released its new trade strategy *Trade for All: Towards a more responsible trade and investment policy*, which builds on the EU's track record to promote trade relations in order

to deliver real economic results for consumers, workers, and companies, to champion sustainable development and to protect human rights (European Commission, 2015). This strategy aims to overcome the traditional dilemma between interests and values, arguing that opening foreign markets does not require the EU to compromise on core principles – namely human rights – or on safety, quality, environmental and governance standards. Indeed, some of the standards that the EU hopes to ensure through free trade agreements, such as the abolition of child labour, non-discrimination in the workplace, high levels of occupational health and safety, decent working conditions, and far-reaching commitments on environmental protection, are in line with the Chinese government’s agenda of developing a more socially and ecologically sustainable path of economic development. However, it is far from clear how emphasising some other points, such as granting freedom of association and collective bargaining, ending forced prison labour, or putting into practice a stricter policy on export controls of dual use goods for preventing their misuse that results in human rights violations, will not hinder a prospective trade agreement with Beijing, since the Chinese authorities have given no sign of being willing to change their stance on some of those sensitive issues. In other words, the dilemma is still there and Brussels could be forced to compromise on some values and standards in order to sign an FTA with China at the expense of its reputation as a normative power.

In addition, the *Trade for All* strategy announces the EU’s expectation of conducting more balanced trade relations with its partners, with a particular mention of the countries that have recently graduated out of the Generalised Scheme of Preferences, as China did on January 1<sup>st</sup> 2015. Brussels intends to reach close to full reciprocity in its future bilateral agreements with those countries that have previously enjoyed preferential access to the European market in an attempt to favour their development. This implies the need to conduct some adjustments to the way the EU and those countries have traditionally traded. Consequently, even if the *Trade for All* strategy depicts the Pacific region as its second priority right after the negotiation of the Transatlantic Trade and Investment Partnership, there is not even a single reference to the convenience of negotiating an FTA with China at the moment, whereas the conclusion of the EU-Japan FTA is labelled “a strategic priority”. On the contrary, the strategy underlines the obstacles impeding the beginning of FTA negotiations with Beijing and asks China to carry out some domestic reforms in order to open up that possibility.

## **Obstacles to an EU-China FTA**

Some of the characteristics of the Chinese politico-economic system conflict with the way the EU runs its economy and the international standards for economic governance it has helped to establish, namely: a financial system geared to supporting state-owned enterprises (SOEs), which receive significant public support, for example, in the form of grants, preferential loans, subsidies, and low-priced land, obtaining in this process an unfair competitive advantage over foreign-invested companies; weak protection of intellectual property rights, due to the lack of effective enforcement of China’s laws and regulations by the responsible administration and courts; and widespread restrictions on foreign investment (Okano-Heijmans & Lanting, 2015). China’s restricted

foreign investment regime is reflected in the OECD Foreign Direct Investment Regulatory Restrictiveness Index. On a scale from 0 (open) to 1 (closed), China received the second highest value of all 58 countries included in 2015, 0.386, whereas the corresponding values for the EU member states ranged from 0.004 (Luxemburg) to 0.106 (Austria). All this translates into an uneven playing field for European companies operating in China.

In this context, European companies complain in different editions of the Position Paper published annually by the European Union Chamber of Commerce in China about discrimination in favour of local firms, especially Chinese SOEs, regarding public financial support, government procurement, and the targeted enforcement of Chinese laws and regulations, for example those supposed to protect intellectual property rights. These allegations of systematic discrimination and insufficient investment protection contrast with the official claim of the Chinese government to provide non-discriminatory post-entry treatment to foreign companies in China. The survey data conducted by the European Union Chamber of Commerce in China among Chinese investors in Europe and European companies in China, shows that Chinese companies face fewer market access obstacles and feel treated much more fairly in Europe than their European counterparts do in China (The European Union Chamber of Commerce in China, 2013). Chinese companies tend to praise the EU investment environment as open and welcoming, and the difficulties they report in operating on the ground are much more related with working in an unknown and highly regulated market than with discrimination or legal uncertainty. This is not to deny that Chinese companies have also raised concerns about a numbers of barriers they face when investing in Europe, including sectoral investment restrictions and different kinds of *ex ante* authorisation procedures, plus large difficulties and allegedly unfair treatment for obtaining visas and work permits for their Chinese staff.

Because of those difficulties, the EU argues that the conditions are not right for negotiating an FTA with China at the moment. The European Commission is only interested in negotiating an ambitious trade agreement, which could bring substantial improvements in terms of market access and regulatory certainty and protection for EU companies in China, but it is far from clear that the Chinese leaders are willing to implement the range of domestic economic reforms required to assure a much more balanced relationship in the regulations EU companies face in China and Chinese companies face in Europe. This argument was put forward on February 2016 by Commissioner for Trade Cecilia Malmström, during an event organised in London by the China Association, when she pointed out three internal reforms China would have to implement before opening negotiations on an EU-China FTA: the state would need to be a regulator not an economic operator; inefficient companies should be allowed to go bankrupt; and adjustments should be made to reduce overcapacity (Malmström, 2016b).

The most pressing issue for the European Commission is overcapacity, since European business associations are publicly denouncing how the use of unfair trade practices by Chinese companies to place their massive surpluses on the European market is damaging their interests.

The steel sector is the most notorious example of China's overcapacity and the EU is using its trade defence system quite actively to alleviate this situation, with 16 trade defence measures in place and several ongoing investigations against imports of Chinese steel products. The concerns of the European firms have been echoed by some members of the European Parliament, who have joined the demonstrations organised by steel industry organisations, and by the governments of some member states. Seven ministers from Germany, Italy, the UK, France, Poland, Belgium and Luxembourg sent a letter to the European Commission in early February underlining anxieties about the future of Europe's steel industry. The role of the European Parliament in influencing EU-China trade relations should not be neglected, since the concluded agreements on key issues such as the BIA, granting China market economy status, and a bilateral FTA must be approved by this chamber. This is not just a formality, but an additional political barrier, because the European Parliament is less enthusiastic about trade liberalisation than the European Commission, as demonstrated by the non-binding resolution it passed against market economy status for China on May 12<sup>th</sup> 2016.

In an effort to reinvigorate the abovementioned economic reforms in China, which could boost EU-China trade, last January Commissioner Malmström wrote a letter to the Chinese minister of commerce, Gao Hucheng. The domestic reforms in China favoured by the EU are actually in line with the Decision on Major Issues Concerning Comprehensively Deepening Reforms published by the Chinese authorities after the Third Plenum of the 18th Central Committee of the Chinese Communist Party, which pledged a decisive role for the market in the Chinese economy and the ensuing reform of the SOE system. However, even if there is consensus in Beijing and Brussels on the exhaustion of the growth model based on low labour costs and a high investment rate that has propelled the Chinese economy in the last decades, and on the benefits of adopting a development model more focused on the domestic market and higher value added activities, there are discrepancies on the pace of the reforms needed to achieve it.

Brussels would like the reforms to be implemented as soon as possible, but this is a controversial issue inside the Chinese regime. The main Chinese leaders are concerned about the political cost of a swift implementation of the announced reforms, due to the negative short-term effects on employment and the resistance of some quarters of the regime – such as local governments and SOEs – with vested interests in keeping the former economic model, which provides them with easy access to capital with lax supervision on its use. This is perhaps the reason why major economic reforms under the Xi Jinping leadership have yet to be seen. Among 118 initiatives presented after the Third Plenum in November 2013, only 12 have been fully implemented, whereas 78 have been partially implemented and 28 have experienced no improvement or even setbacks (The European Union Chamber of Commerce in China, 2015: 401-426). Actually, projects leading to a more open Chinese market – such as the free trade zones – have made limited progress or been completely abandoned. In addition, worrying steps backwards can be seen in the new law on national security, in the law on non-governmental organisations and in the field of cybersecurity. Leaving aside the impact of those measures on human rights, the

negative effects from those restrictive policies could also be felt in the field of trade. For example, those laws use a very vague and wide definition of national security, which creates uncertainty and could easily be used to restrict market access to foreign investment and to increase government interference in foreign companies, which could be forced to expose intellectual property further and to follow unjustified data localisation and data storage requirements.

This mixed record on economic reforms by the Xi Jinping-Li Keqiang leadership raises the following questions: will the Chinese government behave as it did in 2001, when it resorted to international commitments – China’s accession to the WTO – to move forward with contested domestic economic reforms? Or is Beijing actually attempting to preserve widespread protectionist and discriminatory measures and to normalise those standards in global economic governance? The EU wants to be sure we are dealing with the first scenario before seriously considering the negotiation of an FTA with China.

## Current negotiations

Today, there are two pending issues that might influence the probabilities of an eventual launching of FTA negotiations between Brussels and Beijing: the conclusion of the EU-China BIA and Brussels’ decision on whether granting China market economy status.

Since the publication of the EU-China 2020 Strategic Agenda for Cooperation (European Union External Action, 2013), the Commission has consistently argued that the successful conclusion of the ongoing BIA negotiations, launched at the 16th EU-China Summit in November 2013, is a prerequisite for conducting a feasibility study for a bilateral FTA.<sup>1</sup> From that perspective, the BIA is not just a way of reducing investment restrictions to each other’s market and for improving legal certainty and protection to investors of both sides, but also a signal of the commitment of the Chinese authorities to implementing the kind of significant domestic reforms required for establishing a more level playing field for European investors in China, particularly granting the market a bigger role in the economy at the expense of the state, with the ensuing reform of the SOEs system (Ewert, 2016).

The key point in this regard is the inclusion in the BIA of market access provisions in the form of effective non-discrimination for European investors. The EU is demanding China make a clearer commitment to the national treatment standard with respect to both the pre-entry and the post-entry phases (Bickenbach, Liu, and Li, 2015), a principle whereby a host country extends treatment to foreign investors that is at least as favourable as the treatment it accords to national investors in like circumstances. In order to reach a more balanced investment environment, Brussels expects China to follow a short negative list approach, granting pre-entry national treatment to foreign investments in all sectors not included in the list, since the EU is already much more open to Chinese investors than the other way around.

This requirement is clearly beyond the scope of the existing investment agreements between China and the EU member states, and of most

1. In the *Trade for All* strategy it is argued that the signing of an EU-China BIA would also facilitate Chinese participation in the Commission’s investment plan for Europe as well as European participation in China’s “One Belt, One Road” projects (European Commission, 2015: 31).

recent bilateral investment agreements signed by China with other partners such as Canada, Korea and Japan. In those agreements China has only so far committed not to increase discriminatory treatment and to progressively remove non-conforming measures, de facto allowing Beijing to keep laws and regulations towards foreign investors that are incompatible with national treatment. Conversely, although China seems to be willing to accept a negative list approach, it would rather follow a more protectionist approach with a long negative list. Anyway, it remains to be seen to what extent China is willing to liberalise its foreign investment regime in order to close a BIA with the EU, which would soften the EU's stance on Chinese FDI inflows and increase the prospects of a bilateral FTA negotiation.

The same way the EU insists on signing a BIA before negotiating an FTA, the Chinese authorities warn that they will not agree on a BIA until the EU grants China market economy status. Indeed, the EU's decision on granting China market economy status is the most pressing issue for EU-China trade relations, since it could trigger a trade war between Brussels and Beijing and is forcing Europe to update its trade defence instruments (Huotari, Gaspers, and Böhnke, 2016).

Treating China as a non-market economy allows the EU to resort to the analogue country system to calculate reference prices in anti-dumping cases, instead of using domestic prices in China. It is widely accepted that this methodology distorts the dumping margin upwards and thus, for China, being recognised as a market economy is not just a question of status. Referring to section 15 of China's Protocol of Accession to the WTO, Beijing considers that all countries that have not recognised China as a market economy yet will have to do so before December 11<sup>th</sup> 2016, when it will be 15 years since China joined the organisation. If the EU accepts the Chinese position, it would be easier to move on with the BIA negotiations; however, doing so without new anti-dumping measures would severely damage EU economic interests, particularly in the steel sector, and could fuel Euroscepticism at a very delicate juncture (Godement, 2016). On the contrary, not granting China market economy status would take a toll on bilateral relations, as well as undermining the EU's reputation as a normative power that abides by international law regardless of whether it is aligned with its short-term national interest.

The most likely option for the EU is to recognise China as a market economy as soon as it is able to pass new anti-dumping legislation to protect the legitimate interests of European companies against unfair trade practices. In order to do so the EU is designing a plan to introduce new trade defence mechanisms similar to US-style anti-dumping duties and push China to cut overcapacity. The recent announcement of an EU-China joint working group to monitor pricing and public subsidies given to steel mills in China is a positive step in that direction. Anyway, the EU will not be able to come up with a viable alternative before the mid-December 2016 deadline, opening up the possibility of a rocky period for EU-China relations. To avoid this scenario, in which China could decide to legally challenge the EU at the WTO or the European Court of Justice, or to fight a trade war, it is of great importance for Europe and China to reach a compromise on this issue.

## Conclusions

Both the EU and China want to be treated with reciprocity by the other side. The EU wants a level playing field for European companies operating in China, hence it asks the Chinese government to finish with the unfair advantages it provides to local companies, particularly for SOEs, and the multiple barriers it has erected against foreign investors. For China, being recognised as a market economy is both a question of status – not to be grouped with countries like North Korea and Belarus – and a way of reducing the set of anti-dumping measures available for Europe to use against Chinese imports.

For Europe, the key question is whether China really wants to move forward with the reforms of its economic system in order to play by the same rules as the OECD countries or just hopes to maintain unfair government backing of Chinese companies and to get those practices normalised in global economic governance. Indeed, the first scenario would be much more favourable for EU-China trade relations and could lead to the EU granting market economy status to China and implementing a trade defence system without discriminatory measures against Chinese products; as well as to the signing of a BIA and the conducting of a feasibility study for an EU-China FTA. Unfortunately, the development path the Chinese authorities will choose is far from clear. Meanwhile, China feels that the time has come to be taken more seriously by Europe. The EU must realise how relevant China is for the European economy, the fact that Chinese overcapacity is forcing Brussels to come out with a new trade defence system is a telling example of its importance, to avoid embarrassing and problematic situations like not having a position on China's market economy status before the deadline fixed by China's Protocol of Accession to the WTO.

EU-China trade relations are probably going to navigate turbulent waters in the following months, unless China shows more determination to establish a level playing field for European companies operating in China and to tackle overcapacity, and the EU agrees on a new trade strategy which does not discriminate against Chinese products.

## References

BICKENBACH, Frank, LIU, Wan-Hsin, and LI Guoxue. "The EU China Bilateral Investment Agreement in Negotiation: Motivation, Conflicts and Perspectives". *Kiel Policy Brief*, no. 95, October 2015. [Date accessed 28.09.2016]. <https://www.ifw-kiel.de/wirtschaftspolitik/zentrum-wirtschaftspolitik/kiel-policy-brief/kpb-2015/kiel-policy-brief-95>

CENTRAL COMMITTEE OF THE COMMUNIST PARTY OF CHINA. 16 January 2014. [Date accessed 28.09.2016]. [http://www.china.org.cn/china/third\\_plenary\\_session/2014-01/16/content\\_31212602.htm](http://www.china.org.cn/china/third_plenary_session/2014-01/16/content_31212602.htm)

DE JONQUIÈRES, Guy. "The EU and China: Redressing: An Unbalanced Relationship". *ECIPE Policy Brief*, no. 1, 2016. [Date accessed 28.09.2016]. [http://ecipe.org/app/uploads/2016/01/Policy-Brief-012016-\\_The-EU-and-China.pdf](http://ecipe.org/app/uploads/2016/01/Policy-Brief-012016-_The-EU-and-China.pdf)

EUROPEAN COMMISSION. *Trade for All: Towards a More Responsible Trade and Investment Policy*. October 2015. [Date accessed 28.09.2016]. [http://trade.ec.europa.eu/doclib/docs/2015/october/tradoc\\_153846.pdf](http://trade.ec.europa.eu/doclib/docs/2015/october/tradoc_153846.pdf)

EUROPEAN UNION EXTERNAL ACTION. *EU-China 2020 Strategic Agenda for Cooperation*. November 2013. [Date accessed 28.09.2016]. [http://eeas.europa.eu/china/docs/20131123\\_agenda\\_2020\\_\\_en.pdf](http://eeas.europa.eu/china/docs/20131123_agenda_2020__en.pdf)

EWERT, Insa. "The EU–China Bilateral Investment Agreement: Between High Hopes and Real Challenges". *Egmont Security Policy Brief*, no. 68, 2016. [Date accessed 28.09.2016]. <http://www.egmontinstitute.be/wp-content/uploads/2016/02/SPB68-Ewert.pdf>

GODEMENT, François. "China's Market Economy Status and the European Interest". *ECFR Policy Brief*, no. 180. June 2016. [Date accessed 28.09.2016].

[http://www.ecfr.eu/page/-/ECFR\\_180\\_-\\_CHINA\\_MARKET\\_ECONOMY\\_STATUS\\_AND\\_THE\\_EUROPEAN\\_INTEREST\\_\(002\).pdf](http://www.ecfr.eu/page/-/ECFR_180_-_CHINA_MARKET_ECONOMY_STATUS_AND_THE_EUROPEAN_INTEREST_(002).pdf)

HUOTARI, Mikko, GASPERS, Jan and BÖHNKE, Olaf. "Asserting European Interests: How Brussels Should Deal with the Question of China's Market Economy Status". *MERICs China Policy Brief*. January 2016. [Date accessed 28.09.2016].

[http://www.merics.org/fileadmin/user\\_upload/downloads/China\\_Policy\\_Brief/China\\_Policy\\_Brief\\_January\\_2016.pdf](http://www.merics.org/fileadmin/user_upload/downloads/China_Policy_Brief/China_Policy_Brief_January_2016.pdf)

MALMSTRÖM, Cecilia. "China EU- A Partnership for Reform", 28 January 2016a. [Date accessed 28.09.2016]. [http://trade.ec.europa.eu/doclib/docs/2016/january/tradoc\\_154182.pdf](http://trade.ec.europa.eu/doclib/docs/2016/january/tradoc_154182.pdf)

MALMSTRÖM, Cecilia. "The EU and China: Trade and Investment in the Global Economy", 25 February 2016b. [Date accessed 28.09.2016]. [http://trade.ec.europa.eu/doclib/docs/2016/february/tradoc\\_154322.pdf](http://trade.ec.europa.eu/doclib/docs/2016/february/tradoc_154322.pdf)

OKANO-HEIJMANS, Maaïke and LANTING, Daniel. "Europe's Response to China's Activism Balancing Hope and Fear in the New Age of Global Economic Governance". *Clingendael Report*, October 2015. [Date accessed 28.09.2016]. <https://www.clingendael.nl/sites/default/files/2015%20-%20Europe%27s%20Response%20to%20China%27s%20Activism%20-%20Clingendael%20Report%20MOH-DL.pdf>

THE EUROPEAN UNION CHAMBER OF COMMERCE IN CHINA. *European Business in China Position Paper 2015/2016*. Shanghai: The European Union Chamber of Commerce in China, 2015.

THE EUROPEAN UNION CHAMBER OF COMMERCE IN CHINA. *European Business in China Position Paper 2013/2014*. Shanghai: The European Union Chamber of Commerce in China, 2013.

