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## THE CHINA-EU RELATIONSHIP: Trade But Verify

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**T**he EU (and the US) have been extremely naïve in the way they have developed their trade relationship with China. As long as the Chinese Communist Party (CCP) has such an extensive control over the institutions of the state and the levers of the economy there is little likelihood the turn of the century Western hope of a liberal open market China will be realised. Furthermore, the CCP injects such dysfunctionalities into the Chinese economy and state system that China threatens both its own economic well being and security and that of the EU and US as well. This does not mean that the EU and the US should not trade with China. Rather it means that the West has to take measures to protect itself from the damage that China can inflict on it, whilst seeking to encourage China in the direction of trading with us on a normal commercial basis. To that end the EU needs in trade terms to paraphrase President Reagan, to 'trade but verify', trade but recognise who we are really dealing with, protect our interests and channel their trading operations in a direction which encourages commercial but not politically driven trade.

### China the Hope and the Reality

In 2001 China supported by the United States and the European Union joined the World Trade Organisation. What both the US and the EU hoped was that China would become the third pillar of an open modern international trade system. This was part of a greater Western hope that China was moving in the direction of adopting a liberal, rules based system of governance, which would ultimately lead to some form of democratic system. In 2001 this did not seem a wildly unrealistic proposition. China had liberalised its markets, downsized its state-owned enterprise system and permitted wave after wave of foreign investment to enter the country<sup>1</sup>. Economically this appeared to be the basis of a win-win-China would obtain substantial economic growth and become a partner in the open trading system, and

**The Communist Party injects such dysfunctionalities into the Chinese economy and state system that China threatens both its own economic well being and security and that of the EU and US.**

**The danger of Chinese economic policy amounting to 'eating the future' is underlined by the fact that in 2015 local and central government and corporate debt amounted to 283% of GDP.**

**All the supposed independent state agencies, all state owned enterprises and all private businesses of any importance, all media organisations and virtually all the banks, comply with the directions of the Chinese 'Party-State'.**

**The policy of maintaining China's growth at around 6% rapidly ramped up Chinese indebtedness to 283% of GDP and resulted in huge levels of dumping on global markets, increasing trade friction with the US and the EU.**

**Given the capacity of the Party to control Chinese entities through bank finance, direct appointment and party committees, there is a compelling argument for limiting Chinese ownership or control in strategic sectors such as telecommunications, energy and transport firms.**

**The EU needs to develop an effective response to threats posed by Chinese trade and investment policies.**

**An effective system of foreign investment review should include review of critical sectors such as energy, transportation, telecommunications, finance and defence.**

1. Kroeber, Arthur. *China's Economy: What Everyone Needs to Know*. OUP (2016) 49

the US and the EU would obtain access to the fast-developing Chinese market. Politically, although the Chinese Communist Party (CCP) still ran the country, the press had become much more open, independent institutions and a distinct legal order were being established, and political constraints were being imposed on the CCP senior leadership in particular term limits. Furthermore, as the rhetoric and plans of Chinese Party Congresses at the end of the 20<sup>th</sup> and early 21<sup>st</sup> centuries themselves suggested that the senior leadership of the CCP understood that the next stage of economic development would require significant political liberalisation. They appeared to understand that for China to succeed economically in the 21<sup>st</sup> century it would need a more responsive and decentralised consumer driven economy. Such an economy by its very nature would not be amenable to top down control by the CCP. Recent history combined with economic and political incentives therefore provided real hope of a peaceful rise of a liberal and prosperous China.

## There is little likelihood the turn of the century Western hope of a liberal open market China will be realised.

Two decades later those hopes have been dashed. Almost as soon as China had joined the WTO it began closing its markets to foreign capital<sup>2</sup>; it then imposed more and more restrictions on foreign firms trading into China and firms establishing themselves locally unless they were willing to surrender knowhow and intellectual property. At the same time China enthusiastically made the most of trade access provided to it by WTO accession, as the economy boomed via exports. The key moment of change however was the 2008 financial crisis. It saw China then abandon most of the remaining economically liberal trajectory that had been in place prior to 2001. In the face of collapsing demand from the West for its products, the CCP went back to the tried and trusted method of using the party-state controlled banks (which is almost all of them) to fund expansion of the state owned enterprises (SOEs) and state construction projects. The net effect of this programme was to ensure current economic growth, while undermining the prospects of developing a high value added, consumer orientated decentralised economy in the future. The danger of post-crisis Chinese economic policy amounting to 'eating the future' is underlined by the fact that in 2015, local government, central government and corporate debt amounted to 283% of GDP, with three quarters of that debt being incurred since 2008<sup>3</sup>. This funding of over capacity has led China (by no means 50% of the world economy) to produce 50% of the world's steel, aluminium, concrete, flat glass and

chemicals (in a number of key sectors)<sup>4</sup>. This in turn has led to widespread dumping, distorting trade flows, and providing the basis for bigger international trade disputes. Equally the political hopes of reform have dwindled, especially since the ascent of Xi Jinping to the Presidency in 2012. What press freedom there was has been curbed; independence in Chinese institutions has been quashed and term limits have been abandoned<sup>5</sup>.

### Recognising the Threat Posed to a Modern China by the CCP

The hope at the end of the 20<sup>th</sup> century for a benign rise of China in the 21<sup>st</sup> century was understandable given the initial market opening and liberalisation of China embarked on from 1993-2001. However, a closer examination of how the CCP remains interwoven around the state institutions and economic life would have revealed how profoundly misplaced was that optimism. The CCP controls all state institutions at the central, regional and local

level. All the supposed independent state agencies -from the competition authority to the stock exchange, the courts-, all state owned enterprises and all private businesses of any importance, all media organisations and virtually all the banks comply with the directions of the Chinese

'Party-State'. Control is exercised in manifold ways. For example, the organisation department of the CCP ensure the appointments to the top 5000 or so state positions, from central and regional governments, state agencies, judicial offices, heads of universities, media groups and the principal centrally controlled SOEs (48 of which are in the Fortune top 500 global companies in 2017). In addition, two particular mechanisms cast a much wider net over the economy. One is that any business of any size must establish a party committee. The party committee is able to exercise significant influence over its commercial direction and personnel appointments. The second is that access to capital from the party-state controlled banking system is only available if you are willing to toe the line. Combined these two mechanisms significantly extend the control of the CCP over almost all of the economy. This is reinforced at regional and local level by regional and local organisation departments and regional and local banks to reinforce control.

These networks give the CCP not only immense control over all arms and emanations of the state as well as business and finance, but they also create huge disincentives for the CCP senior leadership to embrace reform. This centralised party-state controlled system was useful in the early years of economic development to push China rapidly forward. Now it gets in

2. For a detailed report on the opaque processes used to block FDI see *China's Approval Process for Inbound Foreign Direct Investment: Impact on Market Access, National Treatment and Transparency*, US Chamber of Commerce (2012) 35. For a description of the closing of the Chinese FDI window see Kroeber, op cit., 51.  
3. Shambaugh, David. *China's Future*. Cambridge: Polity Press, 38. 2016

4. The scale of this overcapacity and China's responsibility for it is underlined by the fact that since 2004 there has been a 57% increase in global production capacity with 91% of that increase being Chinese. Overcapacity in China: *An Impediment to the Party's Reform Agenda*, EU Chamber of Commerce in China, (2015) 16. More broadly the Overcapacity in China report lays out in detail all the market sectors where China has over 50% of global production.  
5. McGregor, Richard. *Echoes of Mao as Xi Jinping Ends Term Limits*. Lowy Institute, 26th February 2018.

the way of further developing China any further. Creating a complex, sophisticated high value added economy which will allow the country to become the world's largest economy is a threat to almost all those appointed by the CCP's organisation department, the members of party committees in major firms, the universities or the media and the banks. An economy in which information and capital flow easily does not need organisation department appointees to allocate capital and control information. Equally, such an open market is also a threat to the CEOs of state owned enterprises, and their regional government partners, as nimbler competitors enter the market.

The perverse incentives of the CCP and the party-state apparatus can be seen in play in their reaction to the 2008 economic crisis. Rather than accepting the need to rationalise production in the face of the collapse of market demand in the West, and seek instead to increase domestic consumption and move up the value chain the CCP reverted to type. While there was some shift to greater domestic consumption, the major CCP response was 'old school'. The banks were ordered to provide capital to SOEs to expand production, and local and regional governments went on an infrastructure spending spree. The overall impact was to maintain Chinese growth at around 6% in the post crisis years, but at huge cost. This policy as indicated above rapidly ramped up Chinese indebtedness to 283% of GDP and it resulted in huge levels of dumping on global markets, increasing significantly levels of trade friction with the US and the EU.

### **Understanding the threat Posed by Modern China to the EU**

The modern Chinese party-state poses several threats to the EU. The first revolves around Chinese foreign direct investment (FDI). Since 1945 FDI has largely been either a matter of FDI between OECD Western states, or from OECD states to developing countries. The odd OPEC trophy asset, or Russian oligarch buying villas in Spain or townhouses in London, there has been little other FDI entering OECD states. However, since the 'Go Out' strategy launched in 2002 China has become an increasingly major FDI player globally. In 2017 China to EU FDI flows amounted to just short of €30 billion, of which three quarters of those investments were in France, Germany and the United Kingdom.

The EU is a particular target, because access via the US foreign direct investment law, CFIUS (Committee on Foreign Investment in the United States) makes it more difficult to acquire in the US than in the EU. A good example of the CFIUS effect on the EU was the acquisition of the European life sciences giant Syngenta in 2016 by Chemchina. The latter would not attempt to acquire a US life science company for fear of CFIUS. It focussed instead on Syngenta, where its only major hurdle was the EU merger regulation. One can at first sight take the view that the *Chemchina/Syngenta* deal was just another major commercial merger deal. On closer examination the problems emerge. The first is that Chemchi-

na had over \$20 billion of debt on its books. No bank lending on ordinary commercial terms would be able to raise the \$40 billion Chemchina needed to acquire Syngenta. However, because the Party-State wanted Chemchina to acquire Syngenta it ensured that funding and guarantees were put in place.

A further issue is reciprocity, Syngenta would never be able to acquire Chemchina given the extensive formal and informal restrictions to foreign corporate acquisition in China. Over the medium to long term a further concern is that *Chemchina/Syngenta* will now have preferential access in the life sciences and chemicals market in China. It will have unlimited access to capital from state banks, and thick margins from preferential market access allowing it to grow into a dominant firm in China with global reach on the back of its rigged markets and finance. In other words lack of reciprocity, combined with access to non-market finance provided by state owned and controlled banks, allows China to obtain another major illegitimate trading advantage against the EU and the US.

## **Almost as soon as China had joined the WTO it began closing its markets to foreign capital it then imposed more and more restrictions on foreign firms trading into China.**

A broader concern, given the key role of state controlled and directed bank finance combined with the appointment of senior executives in many companies by the Party and the role of Party committees, is Chinese access to EU strategic industries. Given the capacity of the Party to control Chinese entities through bank finance, direct appointment and party committees, there is a compelling argument for limiting Chinese ownership or control in strategic sectors such as telecommunications, energy and transport firms.

A second major area of concern is the impact of massive dumping of products in numerous market sectors from flat glass to aluminium principally by Chinese SOEs. It is worth pointing out that nowhere in the chain of decision-making that caused the dumping is what there could be called a commercial decision. The Party-State owned banks are instructed to provide largely SOEs with loans at low rates of interest, when on no realistic basis can they be profitability repaid. They only provide the loans as they are instructed to do so by the machinery of the party-state. The SOEs take the loans because their job is to maintain employment which helps keep the CCP in power and the senior management in their jobs. The actual production is a by-product of this political and career decision-making process.

EU anti-dumping rules are not designed for dealing with this level of institutional abandonment of commercial decision-making and scale of dumping by a major trade partner. The key issue here is to give the European Commission the capacity to move at speed and at scale to respond to impose dumping duties, and to be able to impose duties at a level which protect legitimate commercial business against multi-sector politically driven product dumping.

A third major concern revolves around China's role in the '16 plus 1' group founded by China ('the plus 1') in 2012. The 16 consist of 11 EU Member States, from Central and Eastern Europe and the Baltic States, and 5 non-EU Balkan States. Lots of promises have been made by China as to new FDI flows arriving in the region. The high point of that promise was the creation of a Chinese infrastructure fund of €10 billion in 2016. China has not subsequently showed any indication of investing on that scale in the region. Far more investment is dangled than actually delivered. Beijing has far less expensively been building relationships via a multitude of conferences and summits with business and political leaders across the region. China appears to be seeking to influence the 16 cheaply without making any major commitment to the region, while using the expectation of investment to undermine resistance to its trade dumping in the region (every one

## The political hopes of reform have dwindled, especially since the ascent of Xi Jinping to the Presidency in 2012.

of the 16 states has a significant trade deficit with China). In respect of the EU 11, Beijing seeks support for China in all EU forums. In particular, they will support China in its international disputes in the South China Sea and oppose EU anti-dumping measures (which would be likely to increase their own trade deficits with China).

A parallel concern which particularly affects the 16 is the Belt and Road Initiative (BRI). The main element of which is the building of new overload trade routes between China and Europe across Central Asia. This has been labelled a new silk road. Amid all the hype it overlooks the reason why the old silk road fell into disuse. First, from around 1650 AD ships became much more reliable, navigation became better and insurance rates fell. As a consequence goods shipping became significantly cheaper than road transport. That economic reality does not change by installing motorways and high speed rail across Central Asia<sup>6</sup>. Second, shipping goods by sea from China permits the use of the high seas to which all have access. By contrast, crossing Central Asia involves relying on several national governments, with the looming presence of Russia casting a shadow along the route. No rail or road infrastructure that China proposes to build is likely to be able to compete on cost or security terms with goods shipped by sea. This analysis underpins the view that BRI is less about connecting Europe and China along new routes as providing new markets for the production over capacity of the Chinese Party-State economy.

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6. Although there is supposed to be a middle market for rail between goods that can go by sea and expensive time critical goods that go by air it is worth noting that currently 'Silk Road' rail transport is being subsidised by the Chinese state with approximately \$300 million of state funds per year. It is also worth noting that the rail traffic is very much one way with very little China import trade along the route, further increasing the cost of the traffic. Jakobowski, Jakub et al, *The Silk Railroad: The EU-China Rail Connection-Background, Interests and Actors*, OSW (2018) 12.

Although China spent approximately \$300 billion so far in developing the BRI project, much of the investment outside China is by loans from Chinese state banks to local firms along the route guaranteed by their own governments. The real concern here is that 16 plus 1 states will be drawn into this web of loan finance for which there is no realistic prospect of economic return. The EU 11 is protected to some degree by EU state aid law which makes many state loan guarantees unlawful. It is noticeable however, that all the 5 non-EU plus 16 states have loans all tied to the BRI project. These are substantial loans (Serbia over \$2 billion, Bosnia \$1.7 billion even Montenegro \$900 million) which may act as a drag on their economic development for years to come.

Montenegro is a case study in the dangers of relying on Chinese loans. The country's total GDP is approximately \$4 billion.

Nevertheless the government in Podgorica struck a deal with the Chinese government to build bridges and tunnels across the Morača river canyon linking the port of Bar on the Adriatic with Serbia. In total the loans to Montenegro amount approximately to \$1 billion. The highway bridge and road project had been previously rejected as economically unviable as a result of studies in 2006 and 2012 which indicated that projected low traffic flows would mean that the state would have to provide a substantial and running subsidy for the highway for decades. The Chinese ignored the earlier reports; commissioned a new report indicating that the highway would be viable and signed a deal with Montenegro to build the road, which will cost Montenegro approximately one-quarter of its annual GDP. In order to fund these borrowings for just the first half of the project Podgorica has to increase taxes and reduce public spending.

### An Effective EU Response

The EU does need to develop an effective response to threats posed by Chinese trade and investment policies. The aim should never to prohibit trade with China but to encourage legitimate commercial trade with no ties to the CCP party-state which could undermine our security. We should also be seeking to ensure real market reciprocity while also encouraging genuine economic reform within China.

The first step for the EU is to not make the situation worse. For example, given the waves of trade dumping by China into EU markets, we must do nothing to actually weaken the existing anti-dumping rules. One particular danger would be to agree to grant China 'market economy status'. Once granted, the Commission would have to rely on costs from the heavily distorted Chinese market which would make it much more difficult to successfully bring anti-dumping cases.

A further example is the recent *Slovakia v. Achmea* case<sup>7</sup>. In that case the European Court of Justice ruled that bilateral investment treaties (BIT) were prima facie contrary to EU

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7. Case C-284/16, Judgment, 6th March 2018. Not yet reported.

law. The problem with this ruling is that it undermines investor protection for Western capital flows into the Baltic and CEE states. It is at the moment the case that it is still overwhelmingly Western capital that flows into the region, rather than Chinese. Removing BIT protection undermines access to Western capital for states across the region making them more susceptible to Chinese capital and Chinese influence.

Proactively the EU and the Member States need to introduce an effective system of foreign investment review (FIR). So far only 12 Member States have any form of FIR. There is no FIR at EU level. The Commission is now consulting on a limited system of FIR. In order to deal with Chinese investment flows both the EU and the Member States all require an effective system of FIR. This should include review of critical sectors such as energy, transportation, telecommunications, finance and defence. It should also include high technology firms as a class given its targeting by the party-state machine. In order to combat specific Chinese features of inward investment any review system should include an analysis of whether the loan of the acquiring company is an arms-length commercial loan or a loan which no commercial bank would be unlikely to ever grant. In any proposed acquisition, the Chinese parties would also have to disclose and update subsequently the names and roles of all members of the party committee which is going to sit as the de facto parallel board of the company.

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Anti-dumping rules need to be streamlined so that the Commission can respond much faster to dumping cases. The Commission also needs to have the power to take full account of the impact of the dumping in calculating the duties to be levied. The Commission also needs to apply extreme vigilance against state guarantees granted by EU states to China, particularly in respect of the flawed Belt and Road Initiative. The danger here is that EU states and candidate Member States could be saddled with huge debts from participation in the BRI, as already has happened in Montenegro. One option for the EU and the candidate Member States would be to amend the Energy Community Treaty<sup>8</sup> and to extend its state aid rules from energy projects to all forms of infrastructure projects. This would significantly limit the potential for China to impoverish and obtain undue influence over candidate Member States.

More broadly much more pressure needs to be brought on China on the issue of reciprocity. It is unacceptable and unsustainable for a major trading partner to ride on the market access granted by the WTO for a decade and a half, while simultaneously progressively closing its own markets to EU and US business. The overall objective of EU trade policy with China should be to encourage trade, but verify, so that the terms of trade do not undermine either our economic or actual security.

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8. The Energy Community Treaty applies between the non-EU Balkan states, Ukraine, Georgia and Moldova and the European Union. Its field of application is currently limited to the EU energy acquis combined with flanking measures in competition, state aid, free movement and environmental law.