Redesigning the European Union’s trade policy strategy towards China

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EXECUTIVE SUMMARY

The European Union's recent trade policy strategy towards China, which focuses on bilateral market access and involves a strong U S-style confrontational stance, is ineffective and short-sighted. Today there exists no genuine dialogue between China and the EU on crucial commercial issues. This paper calls for foresightedness in the European Union's policies towards China. It reviews the EU's strategy and proposes concrete policy options that will allow it to more effectively promote its commercial interests in China, by focusing on topics that will draw support from Chinese interests and bring greater economic benefits for both parties. In trade in goods, the paper proposes a "small bargain", involving the granting of market economy status to China in antidumping, in exchange for China's improvement of its WTO tariff schedule implementation. In its "behind-the-border" rules agenda, the proposed EU-China Partnership and Cooperation Agreement could develop a truly "grand bargain" involving a strong reduction of China's highest barriers on inward FDI in services, better access by China to the EU's services markets, joint procedures to address China's Sovereign Wealth Funds' and EU's norms and standards. It would also involve an important scaling down of Europe's requests in issues such as intellectual property rights. More broadly, the EU should review its current trade policy strategy based on *bilateral deals* and re-focus its trade policy on the WTO. The paper finally argues that EU should also adopt a truly global approach in its trade policy towards China. This means involving not only the United States and Japan, but also successful medium-sized industrial and emerging economies.

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INTRODUCTION[1]

The European Union (EU) has recently changed gears in its trade policies towards China. But is it heading in the right direction? In late 2006, the Commission announced a new trade policy strategy that focuses on bilateral trade deals. It aims to achieve better market access for its industries, namely in Asia and especially in China. Commercial policy relations between the EU and China have significantly deteriorated, and EU policy makers have adopted a confrontational approach towards China. The latter is bound to be ineffective and economically and politically counterproductive.

A redesign of the EU's trade policy strategy is needed. However, it faces daunting challenges. These are threefold. First, China (like the U S) has a fully-fledged foreign policy, allowing its trade policy to focus on business issues, but also to be occasionally the continuation of its foreign policy. By contrast, Europe (that is, the EU and its Member States) cannot counterbalance a tougher stance on trade by concessions in foreign policy matters, simply because it does not now have a common foreign policy and will not have one for years to come.

Second, trade negotiations are not driven by the same dynamics in China and in the EU. Many Chinese firms have not yet developed the same level of efforts as EU firms have for making their case to the trade authorities, and the Chinese press covers less extensively world news than the EU press. Hence, the Chinese trade authorities still enjoy a large freedom of manoeuvre in trade matters. China's trading partners have a hard time "mobilizing" their potential Chinese allies on issues of common interest.

Third, although Europe is a "diminishing giant", its economy will still be larger and richer than China's during the next twenty years. It therefore bears more responsibility than China in building sound, future bilateral relations – like the U S did with respect to Europe from the late 1940s to the early 1960s, when Europe was hesitating between market economy and central planning, and their associated political regimes. Europe will grow richer while China will catch up. This is a positive development – nobody would wish China to stay poor for ever.[2] But, meanwhile, the EU may succumb to the temptations of exploiting short-lived advantages "before it is too late", while rising China may be complacent and procrastinate reforms until it can enjoy its full strength.

In the current extraordinary times, Europe should choose its objectives carefully. In each case it will need to thoroughly assess lost opportunities when insisting too much on a specific topic. It should pick priority objectives that are both beneficial to its long term interests *and* able to draw support from Chinese interests. The latter aspect is crucial, because China's economy is already too large to be influenced exclusively from the outside, and Europe will need to build alliances within China.

In short, Europe should exert foresightedness. It should not hesitate to behave vis-à-vis China as it would like China to behave with regard to Europe two or three decades from now. Such an approach, however, is the exact opposite for the "*raise-the-theoretical-volume-and-do-nothing*" option suggested in some European quarters (Whyte 2007). European policy-makers should be aware of the fact that while China's growth may be strong, it is also recent and will hence be fragile for many years to come. China will sooner or later be hard hit by a domestic downturn. Europe has a special responsibility (and strong interests) not to worsen the situation by an inappropriate trade policy. Admittedly, such a foresightedness is extremely difficult to achieve via trade policy. Indeed, trade policy is often driven by short-termism rather than by strategic views, by restless pressures from narrow domestic lobbies rather than by a global approach, and by unbalanced requests to the partner rather than by a sense of mutual concessions generating joint benefits.

Advocating such policy goals may seem utterly naïve. They certainly do not fit the mood prevailing in Brussels since October 2007. However, it is viable. Business itself is taking such an approach. Indeed. many European firms are investing in China despite low returns from Chinese markets compared to other places in the world. They ultimately do so because they are convinced that sacrificing some short-term profits is necessary to become part of a prosperous Chinese economy and society in the making. This is the strategy behind the motto "competition and co-operation" often used by European businessmen when describing their relations with China. They ultimately do so because they are convinced that sacrificing some short term profits will bring long term benefits. European policy-makers would be well served by adopting a similar long-term perspective.

This Working Paper is organized as follows. Section 1 sets the scene. It provides insights into China's current role in the world trading system, which is much more important than people usually say, and points to China's expected economic development in the coming decades, which is more complex than people usually think. Section 2 focuses on Europe's trade policy strategy towards China in goods. It underlines the weaknesses of the EU's defensive approach, and it tries to propose ways to re-open a true dialogue by tabling a "small bargain." Section 3 focuses on the the more difficult, but much more promising, "behind-the-border" agenda (intellectual property rights, services, investment, norms, etc.). These issues will require the most dramatic decisions from the EU, both in terms of focus and depth. However, they also offer the possibility of a "grand bargain" which will bring huge benefits to the two trading partners and – if well conceived – to the rest of the world. Section 4, after having looked at the interactions between trade and foreign policies of both China and Europe in Africa and in Asia, argues that Europe's current tactic, which favours preferential trade agreements, is a huge strategic, economic and political mistake. The paper concludes by looking at the EU trade policy towards China in a truly global context and calls for the involvement of the U S, Japan and, most important , medium-sized economies as key partners.

SECTION 1. SETTING THE SCENE: CHINA'S ROLE AND WEIGHT IN THE WORLD TRADING SYSTEM TODAY AND TOMORROW

Shaping the EU's trade policy towards China in a desirable way requires two preliminary conditions: to have undertaken an assessment of the real role of China in the current world trading system, and to have a sense of the realities of the Chinese economy, its successes as well as its challenges. The resulting picture following such an assessment strongly suggests that the current European fears, generated by Chinese growth, are exaggerated while the benefits from it are underestimated.

China's systemic role in the world trade regime

China is often criticized for having a mercantilist trade policy in general, and for providing little input into the current Doha Round of trade negotiations in the WTO in particular. This view is not an accurate assessment of the situation.

Firstly, it is important to realize how ambitious China's tariff liberalization has been, regarding its pace as well as its magnitude. It took twenty years for China to cut its average tariff from 60 percent (1985) to slightly less than 10 percent (2006), that is, only three percentage points below the current EU average tariff (see Table 1). The EU needed twice more time for achieving the same result.

Maximum tariffs give an even better view of China's achievement from an economic perspective, because such tariffs actually generate the largest distortions in an economy, hence imposing the largest welfare costs on domestic consumers. In five years (2001-2006) China has cut its maximum bound tariffs by almost half, bringing them closer to the EU level in most industrial sectors, and to a *lower* level in agriculture, despite the fact that two-thirds of the Chinese population are still heavily relying on agriculture.

Perfunctory statements about "China's mercantilism" indeed merit more care and caution. The rapid pace and magnitude of China's liberalization explain, if not justify, today's problems in Chinese tariffs.

TABLE 1. CHINA'S UNILATERAL TARIFF LIBERALIZATION, SELECTED SECTORS

	AVERAGE TARIFFS			MAXIMUM TARIFFS		
	CHINA 2001	CHINA 2005	EU 2006	CHINA 2001	CHINA 2005	EU 2006
AGRICULTURAL PRODUCTS	23.1	15.3	17.8	121.6	65.0	427.9
MANUFACTURING PRODUCTS	14.4	8.8	3.8	90.0	50.0	50.9
CHEMICALS	9.9	6.7	4.3	50.0	47.0	50.9
WOOD, PAPER	12.2	4.3	2.5	38.0	20.0	10.0
TEXTILE	)21.1*	9.7	7.4	)42.0*	38.0	12.0
CLOTHING	)	16.2	10.8	)	25.0	12.0
LEATHER, SHOES	17.4	12.2	7.4	90.0	25.0	17.0
MACHINERY	13.4	8.0	2.1	45.0	35.0	14.0
ALL PRODUCTS	15.6	9.8	6.9	121.6	65.0	427.9

Source: WTO Secretariat, Trade Policy Monitoring Reports: China (2006) EU (2007). *This figure covers both textile and clothing

Secondly, China's massive tariff liberalization has had an indirect, but strong, disciplining effect on the level of tariff protection in other developing countries. When China acceded to the WTO, it "violated" three unofficial principles of a typical developing country's trade policy – "*keep tariffs high, don't bind them, liberalize as slowly as possible*".[3] By shifting to moderate bound tariffs at such a rapid pace, China has indirectly left little choice to India and other emerging economies but to go down a similar path. If these countries want to attract foreign traders and investors, they have to offer tariffs roughly similar to Chinese tariffs. In short, Unwittingly China has done more for the trade liberalization of India and other emerging countries than the EU and the U S during the past twenty years of multilateral negotiations. This is to the benefit of the entire world, including the EU.

Thirdly, in the current Doha negotiations, China has been a key to the sustainability of the so-called "G20" coalition.[4] Established before the WTO Cancun Ministerial to counter the U S and EU opposition to freer trade in agriculture, the G20 has been the latter's main interlocutor since then. A G20 without China would have lost 40 percent of its GDP size (at power-purchasing parity), half of its growth rate (GDP weighted), and many topics to be negotiated, narrowing down the potential scope of compromises. A Doha Round without a G20 including China would have had little chance to achieve meaningful results.

China or Chinas? The Tale of the "Three Chinas"

A decade ago, few Chinese economists thought that China's accession to the WTO would not only be a liberalization process vis-à-vis the rest of the world, but also a driving force for reducing or eliminating trade barriers *within* China, that is, for generating a Chinese "Common Market" – as the GATT did for the EU internal liberalization during the 1960s to the 1980s (Messerlin 2001).

It is indeed crucial to develop a sense of China's economic diversity, in order to assess accurately the competitive pressures that China will exert on the EU's economy, as well as the opportunities that it will offer to European exporters. This in turn is an important part in the shaping of trade

TABLE 2. EU MEMBER STATES AND CHINESE PROVINCES GDP'S PER CAPITA (2005 US DOLLAR AT PPP RATE)

EU Member States and Asian Countries		Chinese Provinces higher estimate [a]		Chinese Provinces lower estimate [b]		Classification W.Bank	Classification WTO
Luxembourg	70014						
Ireland	38058						
Netherlands	34724						
Austria	34108						
Denmark	33626						
Belgium	32077						Developed countries
Sweden	31995						
United Kingdom	31580					High income	
Germany	30496						
Finland	30469						
France	29644						
Italy	27750						
Spain	27270						
Greece	25520	Shanghai	25476				
Cyprus	24473						
Slovenia	23004	Beijing	22285				
Malta	20410						
Czech Republic	20281						
Portugal	20006						
Hungary	17014	Tianjin	18258				
Estonia	16654						
Slovak Republic	15881	Zhejiang	14289			Upper middle income	
Lithuania	14085	Guangdong	13478	Shanghai	13735		
Poland	13573	Jiangsu	12494				
Latvia	13218	Shandong	10257	Beijing	12015		
Romania	9374	Liaoning	9461	Tianjin	9844		
Bulgaria	9353	Fujian	9209				
		Nei Mongol	8659	Zhejiang	7704		
		Hebei	7351	Guangdong	7267		
Thailand	6869	Heilongjiang	7020	Jiangsu	6736		
		Jilin	6760	Shandong	5530		
		Xinjiang	6628	Liaoning	5101		Mostly developing countries [c]
		Shanxi	6135	Fujian	4965		
		Hainan	5543	Nei Mongol	4669		
		Henan	5528	Hebei	3963		
		Hubei	5371	Heilongjiang	3785		
		Ningxia	5182	Jilin	3645		
		Qinghai	5125	Xinjiang	3574	Low middle income	
		Shaanxi	5100	Shanxi	3307		
		Hunan	4821	Hainan	2988		
		Chongqing	4812	Henan	2980		
		Jiangxi	4647	Hubei	2896		
		Xizang	4562	Ningxia	2794		
		Sichuan	4267	Qinghai	2763		
		Guangxi	4233	Shaanxi	2749		
		Anhui	4097	Hunan	2599		
		Yunnan	3907	Chongqing	2595		
		Gansu	3744	Jiangxi	2505		
		Guizhou	2503	Xizang	2459		
				Sichuan	2300		
Vietnam	2142			Guangxi	2282		
				Anhui	2209	Low income	Least Developed Countries
				Yunnan	2106		
Cambodia	1453			Gansu	2018		
Bangladesh	1268			Guizhou	1349		

Sources and notes:
[a] based on previous PPP rates [World Bank 2007a].
[b] based on new (preliminary) PPP rates [World Bank 2007b].
[c] There is no official definition of "developing country" in the WTO.

relations between these two economies in the coming decades. A more nuanced picture of China's economic diversity can be obtained by looking at the per capita gross national product (GDP) of the Chinese provinces compared to the EU's Member States. Such a comparison reveals that, beyond their obvious differences, Europe and China have profound similarities. In particular they share a very significant economic heterogeneity (Messerlin 2007) that makes it difficult to achieve a satisfactory balance of power between the "central" and "local" authorities (He 2007).

Table 2 compares the Chinese provinces' and EU Member States' GDPs per capita – estimated at power purchasing parity (PPP) exchange rates. In the case of China, the two PPP rates available provide a high and a low GDP estimates. [5] The table reveals that there are three groups of Chinese provinces.

The richest group would consist of three to nine provinces, depending on the PPP estimates. With the lower PPP estimate, three provinces (43 million inhabitants, 10 percent of China's GDP) would have a GDP per capita higher than, or as high as, the GDP per capita of five EU Member States. With a higher PPP estimate, nine provinces (420 million inhabitants, 55 percent of China's GDP) would have a GDP per capita higher than, or as high as, the GDP per capita of 14 EU Member States – Shanghai being as rich as Greece, and Fujian as Bulgaria.

These basic facts lead to two conclusions from a trade policy perspective. First, these richest provinces are fast loosing their initial comparative advantages based on low wages. Hence, their competitive pressures on the EU economies will more rarely be based on price competition, but rather increasingly on the quality and the variety of their products, on their capacity to innovate, and on the quality of their industrial relations. This is a type of competition much more familiar to EU firms.

Second, the population of the richest provinces is quickly developing a taste for products and services similar to those consumed in Europe. As a result, EU export opportunities to these provinces will be much less limited to the upper-end equipment goods and to luxury consumer products currently exported from the few most industrialized EU Member States. They will expand to the whole range of equipment and consumer goods (and services) produced by *all* the EU Member States, including the less developed ones.

Such a finding suggests that the current confrontational stance of the EU Commission is badly timed. It occurs precisely when European producers from all the Member States are finally allowed to enter Chinese markets which have a global size equivalent to Spain today (at current exchange rates) and to a full EU in the longer run.

That said, there is a huge difference between the richest Chinese provinces and those lagging behind, with the poorest one (Guizhou) having an average GDP per capita similar to Vietnam or Bangladesh (depending on the PPP estimates). The remaining Chinese provinces can be divided into two tiers. The first tier includes provinces with an average GDP per capita higher than US$ 1,000 (at current exchange rates). These would be considered "developing" economies in the WTO. The second tier includes provinces with a GDP per capita equal or lower than US$ 1,000 (at current exchange rates). These would have the "least-developed economy" status in the WTO. To predict what will happen to these Chinese provinces during the two or three coming decades is difficult. Some of them will follow in the footsteps of the richest provinces at a slower pace. The rest may be constrained by long-term structural weaknesses, as in any continent-wide economy, and may even be a drag on the Chinese economy and society. Such disparities could add to a potential transitory downturn of China's economy.

To sum up, these observations provide a much more complex and promising picture of the Chinese economy than is often seen in the EU perspective. The following lessons can be drawn:

- To perceive the economies of the EU Member States and of the richest Chinese provinces as dominated by "price cut-throat competition" (as is often done in

Europe) is rapidly becoming misleading. The richest Chinese provinces (representing up to 450 millions of inhabitants) are fast becoming similar to the EU economies, both in terms of production and consumption patterns. They thus generate new challenges: a more complex, less brutal competitive process, but also new opportunities for the full range of EU products.

- The recent confrontational approach by the EU towards China in their trade relations occurs at the wrong time – when a potential market of the size of the EU is emerging in China for all the goods and services produced in the whole of Europe (and no longer only for the equipment and luxury goods produced in the most advanced EU economies, as has been the case until now)
- The pressures on the world economy that the richest Chinese provinces have exerted during the last two decades may decline, while the structurally weak provinces may exert increasing domestic pressures on the Chinese economy and society. The latter point is crucial, particularly if China is hard hit by a domestic downturn capable to have a serious impact on the world economy.

SECTION 2. RESHAPING EUROPE'S TRADE POLICY APPROACH TOWARDS CHINA IN GOODS

Until 2004, EU-China trade relations were appreciated by both. Three factors contributed to this. First, the 1985 EU-China Trade Agreement had granted China the "most- favoured-nation" status, extending to China most of the EU concessions granted to the other GATT (WTO) Members. This was in sharp contrast to what happened between China and the U S. From 1989 to 1999, the U S Presidents had to fight every year with the Congress to renew the MFN (or PNTR) status.

Second, China's trade accession negotiations to the WTO were very long (fifteen years) and difficult. Europe had been lenient with China because it decided to free-ride on the U S negotiating leverage. The U S-China agreement on China's WTO accession was concluded in November 1999, six months before the EC-China agreement. It already contained all the key provisions that, later, were included in China's final WTO Accession Protocol. The EU received from China very limited additional tariff cuts (on 150 products, mostly beverages, cosmetics and machinery) and only slightly better market access in retail (lifting of the joint venture restrictions on large department stores), insurance (seven new licenses), and telecommunications (speeding up the market opening).

Lastly, although EU imports from China had become increasingly visible during the late 1990s and early 2000s, before 2004 their composition (labour-intensive industrial products) and growth gave an impression of "*déjà-vu*" (the usual story of an emerging economy during the last fifty years). As the EU trade deficit with the world remained modest (roughly one percent of its GDP, compared to 5 percent in the U S case) EU officials were under little pressure to act on China's trade.

Entrenched EU sectoral protection

However, even during these honeymoon years, a few EU sectors managed to slow down Chinese exports to Europe – at great costs for them and the EU economy. These sectors were labour-intensive (clothing, shoes) or run by skilled lobbies (steel and chemicals).

An ongoing flow of protectionist measures

Antidumping measures have always been the EU's preferred trade barrier vis-à-vis emerging economies. China is no exception. Although the EU has reduced by one third its annual number of antidumping cases against the world in 2002-2006 (compared to 1995-2001) it has kept constant the number of antidumping initiations against China (roughly 6 cases per year for each period), initiating twice more antidumping cases per US$ billion of EU imports against China than against the rest of the world. The complete EU freeze on new antidumping cases from January 2007 to January 2008 was so extreme that it was unsustainable. Now that it has ceased, the uncertainty of what will happen is high.

In 2002, the EU introduced another trade barrier – safeguards – against Chinese exports. These have proven even more damaging than antidumping measures. Safeguards are characterized by a potentially much wider product coverage than antidumping. For instance, the first EU safeguard (against Chinese steel) was equivalent to at least 10 antidumping cases – a feature undermining the apparent stability of the EU antidumping activity against China until 2006 (Kommerskollegium 2004). The 2002 EU safeguard in steel (decided a week after a similar U S safeguard) covered many more countries than China. But, more recently (January 2008) the Chinese government increased export taxes on Chinese steel products in a clear effort to reduce the risks of a new EU safeguard (and to shift the potential rents associated to such a safeguard to public revenues).

In 2005 a second safeguard (under a specific provision of China's WTO accession protocol) was launched against a wide range of Chinese exports of textiles and clothing, from cotton fabrics to men's trousers to brassieres to flax or ramie yarn. The subsequent negotiations ended up in "voluntary export restraints" (VERs) consisting in growth caps re-imposed on EU imports from China for 10 out of the 35 categories of textiles and clothing. This is a measure equivalent to a large number of antidumping cases.

The EU's safeguard against Chinese textile and clothing have had several major negative effects. First, it has re-introduced VERs, a serious blow to the ban on VERs included in the 1995 Uruguay Agreement on Safeguards, *de facto* resurrecting a large chunk of the Uruguay Agreement on Textile and Clothing (ATC).[6] Second, these VERs have been imposed on a retroactive basis, freezing huge amounts of Chinese exports in Chinese and EU ports and generating an embarrassing "*bra war*" between outraged European retailers and the EU Commission. Last but not least, although these VERs have been eliminated in December 2007, most of them (8 out of the 10 categories, that is, T-shirts, pullovers, men's trousers, blouses, dresses, bras, bed linen and flax yarn) have been extended until December 2008 under the form of a "monitoring" mechanism, with the possibility to revert to full safeguard measures if imports rise "dramatically".

Antidumping and safeguards – "trade defence" instruments in the EU legal jargon – deserve several remarks. First, economic analysis shows that an overwhelming majority of these measures amount to plain protection.[7] Of course, the same conclusion holds for China's antidumping cases against EU exporters (Bown 2007). Such measures often impose very high tariffs – on the average, 39 percent on imports from China, compared to 29 percent for those imposed on imports from the rest of the world and to 4 percent for the EU normal tariffs on manufactured products (see Table 1). Since the welfare cost of a tariff is a function of the *square* of the tariff, trade defence measures are very costly for the EU consumers, be they firms or households.

Second, past experience and economic analysis strongly suggest that trade defence measures rarely protect the intended beneficiaries, i e workers or producers of the import-competing sectors (Messerlin 2001). The economic costs of the EU VERs on Chinese clothing for the European consumers are estimated to be roughly five times the amount that would have been necessary for compensating directly the European workers loosing their jobs (Spector 2005). By contrast, as repeatedly shown by the many European antidumping cases against Japanese or Korean firms during the 1980s and 1990s, such measures enforced against firms from innovative emerging economies often induce foreign exporters to upgrade their products even more rapidly than they would have done in the absence of such measures. This accelerates and deepens competition in Europe, and hence renders more difficult the adjustment of the EU import-competing firms. In the same vein, trade defence measures generate artificial motives among foreign firms to invest in markets where they risk to be unable to export anymore. This is best illustrated by the Indian steelmakers, which have swiftly invested in the EC steel sector, ultimately fuelling EU pressures on the Chinese producers and authorities (see above, on Chinese export taxes).

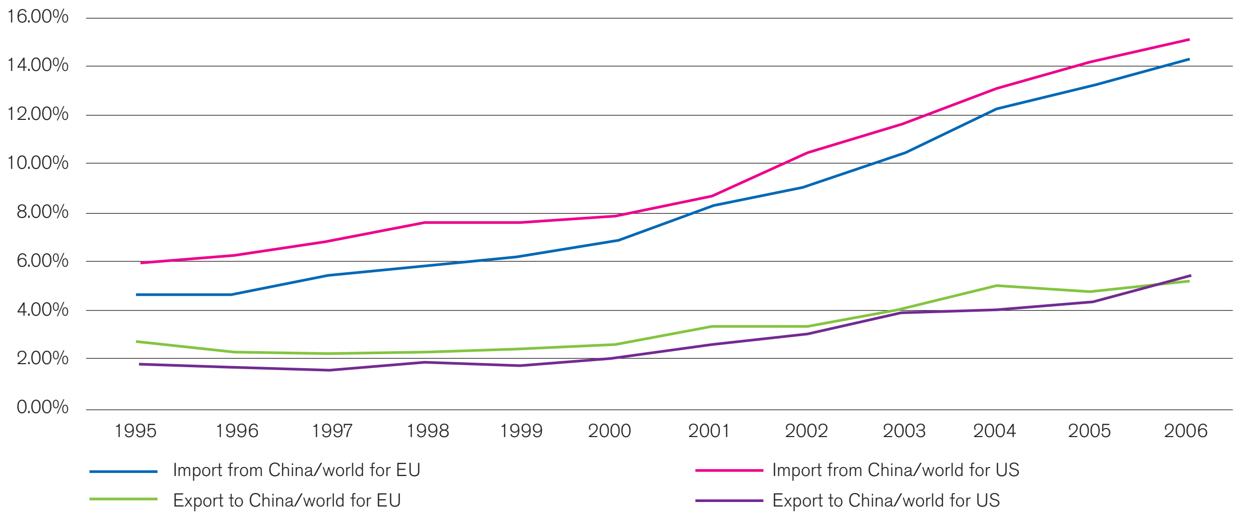
Lastly, trade defence measures are based on an increasingly obsolete view of what a modern industrial economy is, namely a complex production process fragmented among a notable number of countries. Trade defence measures equate industry to manufacturing alone, ignoring the crucial *pre*-manufacturing step (design and preparation of the physical manufacturing processes) and *post*-manufacturing step (logistics, marketing, advertising, etc). These two steps generate a lot of value added in the importing country.[8] For instance, even in labour-intensive products such as shoes, these two steps represent half to three quarters of the European value added in the shoe sector (Kommerskollegium 2007). In short, not only do antidumping and safeguard measures *not* protect the "old" economy (the manufacturing step *per se*), but they might also hurt the "new" economy (pre- and post-manufacturing steps).[9]

As a final point, it must be highlighted that rather than helping domestic industries, trade defence instruments generate unintended, but huge, rents for intermediaries, be they traders – or politicians. Moreover, they often favour the pursuit of anti-competitive strategies by complaining firms, hence magnifying the costs of protection, as best illustrated by Philips and Osram (Siemens). These two biggest European producers of energy-saving lamps launched a case against Chinese lamp producers in 2002. High EU antidumping duties (31 percent on average, up to 66 percent) bankrupted the Chinese firms. This did not stop both EU firms (in particular Philips) from quickly outsourcing their lamp production to China. In 2007, Philips (having become a major importer of bulbs made in China) asked for lifting these duties, while Osram lobbied to get a one-year extension. In short, Philips and Siemens together succeeded in making a mockery of both the antidumping procedure (what is a "domestic" producer?) and the EU energy-saving strategy.[10]

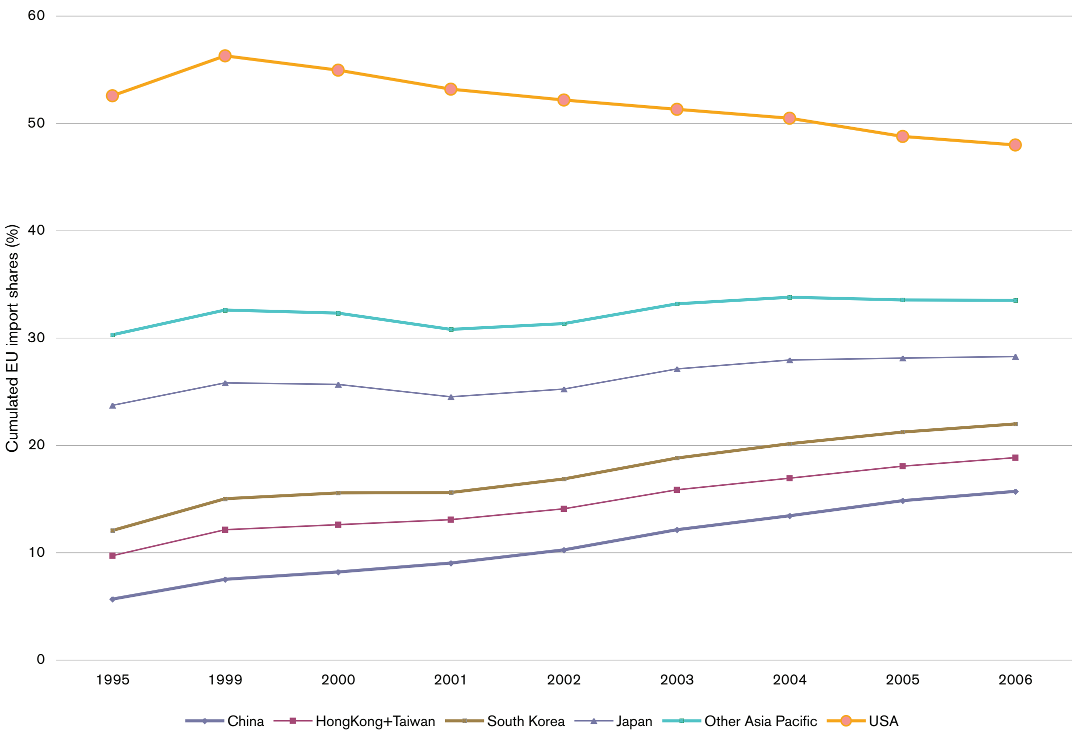
The recent focus on the EU-China trade deficit: wrong and misleading

Since mid-2007, the Commission has adopted a much more confrontational tone in the EU-China trade discussions. It has gone beyond the usual claim that Chinese trade barriers cost 20 billion in lost trade. EU officials began to evoke the Chinese "juggernaut" and to threat to launch cases against China at the WTO. All these declarations remind us of the Japan-bashing 1980s. These triggered an unexpectedly angry reaction from Chinese officials at the 2007 November EU-China ministerial meeting in Beijing.

GRAPH 1: TRADE SHARES OF CHINA FOR EU & US, 1995-2006



GRAPH 2: A BROADER VIEW OF THE EU-CHINA TRADE DEFICIT: THE IMPORT SIDE



The Commission's confrontational tone focuses on the EU-China trade deficit; the latter follows the same pattern as the U S trade deficit with China (see Graph 1). In 2006 a symbolic Rubicon was crossed when China replaced the U S as the EU's largest source of imports of goods.[11] But focusing on this deficit is both wrong and misleading.

Indeed, focusing on any trade deficit *from a trade policy perspective* is wrong. Economic analysis shows that trade deficits are not a matter of concern for trade officials, but for macroeconomic policy-makers (Corden 2007a). In a nutshell, the trade balance of a country reflects its domestic savings-investment balance, those of its partners, and the macroeconomic policies influencing these balances (trade policy instruments have little or no influence on domestic savings and investment decisions). Such a focus from EU trade officials is misplaced: for instance Germany's trade surplus is even larger than China's surplus.

There are additional reasons for not being obsessed by the EU-China trade deficit when elaborating on the EU's trade policy towards China. From 2000 to 2006, the EU27 trade deficit with the world increased from 142 to 196 billion euros (Eurostat 2007) but it has remained a relatively stable share in the EU's GDP (1.6 to 1.8 percent). There is nothing unusual in such shares: the EU's trade deficit with the world has been above 1.5 percent of the EU's GDP every five years (on average) since 1963.

During the same period 2000-2006, the EU's trade deficit with China rose from 49 to 130 billion euros. But this is only half of the story. The other half is the *decrease* of the EU's trade deficit with the rest of the world – from 93 to 66 billion euros. In short, this period has witnessed a massive reshuffling of global trade flows. Many trading partners of the EU export to the EU via China – rather than from their home countries.[12] This is particularly the case of nine large trading partners of the EU (Japan, Korea, Hong Kong, Indonesia, Malaysia, Singapore, Taiwan, Thailand, and the U S). Graph 2 illustrates this evolution: there is an increasing EU import share from China (the rising bottom curve) and a decreasing cumulated EU import share from these nine advanced economies (the narrowing gap between the rising bottom curve and the declining top curve).[13]

TABLE 3. INTRA-EU TRADE AND TRADE WITH CHINA, BY EU MEMBER STATE (EUMS)

	Trade with China				Trade deficit in % GDP	
	annual growth rate (2000-2006)		export-import ratio		trade with China	intra-EU trade
	export	import	2000	2006	[a]	2005
	[1]	[2]	[3]	[4]	[5]	[6]
Trade with China: EUMS with export growth rates higher than import growth rates						
Latvia	133.0	34.4	0.4	10.5	-1.1	-16.2
Estonia	76.4	12.5	4.3	63.6	-1.1	-11.8
Malta	72.7	9.6	3.3	50.0	-1.3	-30.0
Slovakia	61.1	25.4	5.2	23.6	-1.5	-0.5
Cyprus	44.2	10.3	0.8	3.9	-1.7	-20.0
Hungary	55.3	26.9	4.3	14.3	-4.2	2.8
Poland	33.6	15.6	7.1	17.1	-1.2	-2.3
Ireland	31.9	15.6	22.4	49.5	-0.6	12.2
Portugal	26.2	12.5	13.9	27.7	-0.4	-8.9
Lithuania	39.9	26.7	2.2	4.1	-2.7	-9.2
Slovenia	23.2	12.7	10.7	18.4	-0.9	-9.3
Greece	24.7	15.7	4.4	6.8	-0.9	-9.3
Czech Republic	28.1	22.9	9.5	12.2	-2.3	3.1
France	15.3	11.7	42.0	50.8	-0.5	-2.1
Germany	19.4	16.7	55.2	63.3	-0.7	4.3
Spain	20.7	19.6	13.4	14.1	-1.2	-3.6
Trade with China: EUMS with export growth rates smaller than import growth rates						
Britain	12.3	12.6	17.0	16.7	-1.3	-3.1
Italy	15.7	16.9	33.9	31.8	-0.9	-0.1
Denmark	13.6	15.6	29.7	26.6	-1.2	2.4
Belgium	13.9	16.8	33.4	28.6	-2.4	7.3
Netherlands	20.0	23.6	12.8	10.8	-5.5	23.0
Austria	14.0	19.9	69.6	51.5	-0.5	-4.4
Sweden	1.6	13.2	109.9	57.5	-0.6	-0.6
Finland	5.1	21.1	156.4	66.9	-0.6	-1.0
Bulgaria	31.5	47.8	16.2	8.1	-3.4	--
Romania	11.0	44.7	49.2	10.0	-2.0	--
Luxembourg	21.1	84.6	76.4	6.1	-11.4	2.1
EU-27	16.3	17.4	34.7	32.9	-1.2	--
EC-6 [b]	17.9	18.0	39.4	39.1	-1.2	3.2
EC-9 [b]	10.6	14.9	30.7	24.4	-1.1	-2.6
EC-12 [b]	36.0	23.2	8.4	15.2	-2.0	-1.7 [c]
Eurozone	17.4	18.1	38.8	37.4	-1.1	1.7
Non-Eurozone	11.8	15.5	24.3	20.0	-1.4	-2.0

Sources: Eurostat, Trade Statistical Yearbook [2006], Eurostat Press release [26 november 2007].
Notes: [a] 2006 trade deficit in percent of 2005 GDP. [b] EC-6: the founding EUMS, EC-9: the nine EUMS having acceded before 1995; EC-12: the EU Member States having acceded since 2004. [c] excluding Bulgaria and Romania. Underlined EU Member States are eurozone members in 2008.

In such a context, one may wonder who Europe is ultimately defending. Is it its own industries, or is it the Asian and US industries which have relocated some of their activities to China? In short, the only difference between today and the mid-1990s is that the EU's global trade deficit is not spread over several Asian countries, but that it is concentrated on one of them. This is hardly a reason for deep concerns.

The Commission also focuses on an overall "EU" deficit. This is a profoundly misleading view of the EU economy. Few observers have noticed that, between 2000 and 2006, a majority of EU Member States (16 countries, representing almost two-thirds of EU GDP and population) have exhibited export growth rates to China that are *higher* than their import growth rates from China. This means that their export-import ratio with China is improving, sometimes substantially (see Table 3, columns 1 to 4). In other words, talking about insufficient export growth makes little sense at the *EU level*.[14]

Table 3 provides three key additional observations. First, the new EU Member States (those having acceded to the EU since 2004 (the "EC-12" line at the bottom of Table 3) have, on the average, substantially improved their export-import ratio with China. Second, the EU countries with a deteriorating trade balance with China tend to be among the richest EU Member States. But, they are also those that have clearly chosen the "modern industrial economy" model mentioned above when looking at the EU antidumping policy. It seems thus particularly inappropriate for the Commission to fight the choice of these Member States, all the more since there is no evidence that such a choice is to the detriment of other EU Member States.

Lastly, eurozone members are equally divided between the two groups of EU Member States (those with an improving export-import ratio, and the others). Interestingly, they have a smaller trade deficit with China (in percentage of their GDP) than the non-eurozone members. These crucial observations should be kept in mind when examining the exchange rate issue.

Negotiating about exchange rates: an economic and political trap for Europe

In mid-October 2007 the EU Commissioner for Economic Affairs for the first time breached the official EU silence on the appropriate exchange rate of the Chinese currency (yuan). Since then, the eurozone Finance Ministers and the European Central Bank President have urged China to let the yuan appreciate against other global currencies. Four strong and mutually reinforcing economic and political reasons should induce EU officials to come back to their initial silence in these matters.

First, in a purely economic perspective, predicting the "right" exchange rate is an impossible mission. Indeed, economists widely disagree on the level of the yuan's underevaluation. Estimates run from zero to nearly 50 percent. These diverging results are due to differences in the assumptions made, variables included, etc, as it has been carefully shown by two recent IMF studies (Dunaway & Li 2005; Dunaway, Leigh & Li 2006). A recent study suggests that, if there were an undervalued Asian currency against the dollar, it would be the Japanese yen (Morgan Stanley, quoted by *The Economist*, June 21, 2007). The same study suggests that the euro would be "over-valued" against the dollar by 5 to 35 percent. (These estimates have been calculated before the late 2007 slide of the dollar.) In fact, the inability to predict the "right" exchange rate of a currency (particularly in a fast changing world for an economy changing as fast as China's) is the strongest argument justifying the use of the market mechanism as the best way to determine exchange rates.[15]

Second, consistency with internal economic principles would require caution in introducing currency matters into trade policy towards China. Within the EU, flexible and fixed (the eurozone) exchange rates coexist. Almost all EU Member States, having a trade deficit with other EU Member States, exhibit an intra-EU trade deficit (much) larger than their trade deficits with China (see Table 3, columns 5 and 6). Moreover, out of the 15 eurozone members, 9 have a quasi-permanent trade deficit since 1995, and 5 a quasi-permanent trade surplus (only Italy has significantly shifted from a trade surplus to a trade deficit during this period).

Third, EU *political* reasons also point to treading with caution in currency matters. A few key eurozone members (France, Italy) do not share the generally well-respected tradition of the other eurozone members to let their economy adjust to market-driven exchange rates. Exchange rates remain a deeply internally divisive issue in the eurozone. Better not to wake up the beast, now that it has been put in a cage.

Fourth, the EU has no political interest in following the current U S approach on the exchange rate issue. The current U S-EU alliance on yuan revaluation would inevitably leave the EU on the losing side. The rise of the euro and concomitant fall of the dollar imply that a yuan revaluation satisfactory to U S interests would never be large enough for the EU. When and if the U S gets the yuan realignment it is looking for, why should it continue supporting the EU, at the risk of cooling the Chinese growth engine? This would leave the EU confronting China alone. But, contrary to the U S, the EU, due to its lack of a common foreign poliy, does not have the same negotiating clout, since it is unable to balance a tough position on exchange rates with accommodating positions in foreign policy (or vice-versa).

Last but not least, the yuan exchange rate is not the only – nor even the main – channel of the corrections required by the current situation (Corden 2007b). In the interest of all the countries, including the EU and the U S, such corrections should be as smooth as possible.[16] Smoothness requires more changes than mere exchange rate adjustments. Deeper macroeconomic changes are needed; in particular: (i) an increase in the U S saving rate, (ii) an increase in the Chinese spending rate (Deutsche Bank Research 2007), and (iii) deeper structural reforms in Europe, if Europe wants to go beyond the "quick-win" benefits from a very imperfect Single Market.

Relaunching the dialogue in trade in goods: shaping a "small bargain"

As has just been shown, there are many robust reasons for the EU to drop its current confrontational stance towards China on trade policy and go back to serious negotiations. A majority of Member States are realizing that they are becoming successful exporters to China and are likely to benefit greatly from the huge growth opportunities generated by the rise of such a large market.

Relaunching a serious dialogue with China could be started by tackling a pending, limited but highly sensitive, issue. Since its WTO accession, China has forcefully tried to be granted "market economy status" (MES) in antidumping investigations. Such a status would give Chinese firms the same legal treatment in these investigations than the one granted to the firms of almost all the WTO Members. In 1998, the EU made a first step in this direction by granting China the possibility of a "market economy treatment" (MET), which is a status close to the MES, except that it is granted only on a firm by firm basis, but conditionally on restrictive and unpredictable criteria. [17]

In 2003, China made a formal request to benefit from MES. But the 2006 working document spelling out the new EU-China trade strategy by the EU Commission states that "*the conditions for granting MES to China are not fulfilled*." Such a *status quo* has generated increasing tensions in China which is now considering the issue as a matter of national pride.[18] As China could retaliate with its own antidumping measures against EU firms that are increasingly exporting to China (and against those using intensively EU antidumping procedures) it would be wise for all the EU firms to support an EU initiative on this issue.

An EU proposal to grant China MES could open the door to a true dialogue. It would eliminate the most outrageous procedural biases in the antidumping cases against China. Such biases are simply unthinkable in any fair domestic legal process. It would benefit the vast majority of Chinese firms, i e all those unfairly excluded from the MET conditions, and it would reduce EU antidumping duties on average from 40 percent to 20 percent, which is the current average antidumping duty imposed on alleged dumped imports under MES.

The EU could then argue, with some justification, that granting MES consists in a better enforcement of its commitments associated to China's accession to the WTO. As a result, the EU could offer to trade MES for better enforcement by China of some of its Accession Protocol obligations, in particular a clarification and/or a better enforcement of China's tariffs that have created problems. This proposal would kill two birds with one stone. Indeed, such a clarification could offer the opportunity to close pending disputes between the EU and China, such as the ongoing WTO dispute settlement case on China's tariffs on cars and car parts.

SECTION 3. DESIGNING AN EFFECTIVE "BEHIND THE BORDER" RULES AGENDA

Unitl now, EU-China trade relations have been framed by a treaty dating back to 1985. At that time, the WTO did not yet exist. Trade policies in all countries were generally confined to trade in goods. China was a planned economy starting its GATT accession negotiations. A new China-EU trade agreement is therefore much needed, in particular when it comes to the many issues – often called the "behind-the-border" agenda – that are now a full-blown part of modern trade policies. These issues include rules governing investment, services or intellectual property rights. These are either not at all, or imperfectly, covered by the current WTO negotiations.

In September 2006, the EU and China agreed to launch negotiations on a "Partnership and Co-operation Agreement" (PCA). With a view on the PCA, the EU has pledged to keep its markets open to Chinese exports of goods in order to support China's export-led growth. But, in return, the EU is requesting from China stronger intellectual property rights, more open services, lower restrictions on inward investment, lower non-tariff barriers and subsidies, more transparent and open government procurement, improved norms and standards, a better functioning of the legal regime, etc.

This list of requests is far too long and broad to be a useful guide for the PCA negotiations.[19] As a result, the question is: Which topic(s) should Europe prioritize? In this section we argue that, in an economic perspective, Europe would be best served by focusing on investment in services and on norms and standards. Interestingly, political considerations reinforce such an economic approach. For instance, it is likely to be easier for Europe to find Chinese interests (consumers and/or workers) supporting European requests for opening investment in some Chinese services than to find Chinese interests supporting a strong European stance on intellectual property rights in audiovisuals or in luxury goods.

Discussing "behind-the-border" issues raises a preliminary question: how should the European negotiating side be organized? The behind-the-border issues deeply involve the Member States. Therefore, the existing negotiating organization of the EU, based on a mandate given to the Commission, is bound to be inefficient, and a source of often last-minute conflicts between the Commission and the Member States. This will ultimately breed distrust among Chinese negotiators. Since the various behind-the-border issues do not have the same importance for every member state, a negotiating team should be constituted for each behind-the-border "chapter" (or group of topics). Such a team should include representatives of the most interested Member States in the specific topics included in the agenda, in addition to civil servants from the Commission.

Intellectual property rights

Despite much improved laws, China's enforcement of intellectual property rights (IPRs) remains chaotic. It is unrealistic to expect a quick fix of these complex matters in China's continent-wide, very fragmented, economy. However, the main reason for changing the EU current position should not be short-term realism, but the following long-term basic considerations.

Back to basics

Most IPRs (such as patents or copyrights) are transitory monopolies granted by governments – on behalf of current and future consumers – as a price to pay for promoting innovation. They should not be transitory monopolies granted "for free", that is, generating none or tiny additional innovations (all the more because there are other, competitive, ways to support innovation). As a result, the delicate balance between monopoly and innovation is in constant flux, even in the industrial economies. For instance, the debates on generic and patented drugs,[20] on audiovisual rights (Lévy & Tornile 2006) or on luxury goods (International Herald Tribune 24 November 2007) are raging in many EU Member States.

In fact, many EU firms do operate in China under "reduced" (compared to those prevailing in their OECD markets) IPRs, as documented by a recent study exploring China's IPRs environment (Emerging Market Group, Study12 2007). EU firms have been quoted as not bothering so much about this situation, and not even bothering to register patents in China. They provide several reasons explaining such a restraint, from the expiration of the IPRs in their EU country of origin (pharmaceuticals) to the candid recognition that "there is nothing top-secret" (construction) in their IPRs (Emerging Market Group, Study12 2007, page 19, Box 1).

The bottom line is that, ultimately, EU firms operate in China because they value the expected monopoly rents from their IPRs *less* than the expected benefits from operating in the *de facto* (if not *de jure*) more competitive but large Chinese markets. Had they not been led to this conclusion, they would not have entered the Chinese markets.

In short, there are robust economic arguments suggesting that, in a *private* as well as public perspective, the EU should focus on the few products and services where net benefits from IPRs are clear enough, i e generate innovations that are "serious" enough. The other IPR issues had better be left to private negotiations and settlements. This strategy can help garner support from Chinese consumers. This more focused approach is justified all the more by the fact that the IPR balance of monopoly and innovation, of public action and market forces, is not the same for countries – or provinces – with wide differences in terms of income and technology.[21]

Political considerations reinforce this argument. Negotiations on IPR issues are much more conflict-prone than negotiations on tariffs. When the EU requests China to lower a product tariff, it is perceived as an enemy by Chinese producers (entrepreneurs and workers) of this good, but as a friend by the Chinese consumers of this product – be it Chinese firms using this product as an input for their production, or be it Chinese households. However, when the EU fights for a stronger IPR regime in China, it is regarded as an enemy by *both* the Chinese producers and consumers of the product(s) or service(s) in question, because a stronger Chinese IPR regime would tend to exclude Chinese producers from entering the market(s) in question, *and* to raise the price(s) paid by Chinese consumers. An offensive EU position on IPRs can acheive popular support in China only when the value of patents is very clear to Chinese consumers – such as in the case of substantially new drugs.

From a long-run perspective, the argument for EU restraint in IPR negotiations is even stronger. Looking back, the long history of relations between Europe and China is one of innovations with little consideration for Chinese IPR by Europeans. This does not make negotiations on a strong IPRs regime in China very popular today. Looking into the future, forceful EU demands for strong IPRs in China may be costly for EU producers and consumers in the long run. China is likely to become the largest source of new IPRs in the world – it is largely a matter of time. It is therefore better for Europe and the other industrial countries to have reached an economically sound balance between monopoly and innovation in IPR regulations by then.

To conclude: the opportunity costs of negotiations on IPRs for the EU should be measured by the number and the importance of the other topics abandoned in order to achieve success on the IPR front. For economic and political reasons, these costs are very high. For instance, strong EU action for the elimination of China's production of pirated DVDs is certainly crucial for the revenues of two to three dozens of key EU (and non-EU) film actors and producers. But, to focus on such an issue in the PCA context can only be achieved at the cost of giving up other, in an EU perspective, probably more profitable ambitions, such as IPRs in essential drugs or investment in key services sectors.

Reassessing the EU's own interests in IPR: the "geographical indications" case

"Geographical indications" (GIs) are very high on the Commission's current PCA negotiating agenda. Article 22.2 of the Uruguay TRIPs Agreement requires Members to provide the legal means (i e, GIs) to avoid "*the designation or presentation of a good that indicates or suggests that the good* *in question originates in a geographical area other than the true place of origin in a manner that misleads the public as to the geographical origin of the good*," as well as any use of a designation "*which constitutes an act of unfair competition*." In contrast to patents, GIs do not aim at promoting innovation, but at giving information on "reputation." But, like patents, GIs limit competition by imposing a "register" listing the conditions necessary for benefiting from the desired GI labels (from champagne to Parma ham). The stricter the mandatory conditions imposed by the register, the stronger the implicit degree of monopoly created by the register.

The Commission continues to maintain GIs as a top priority of the negotiations with China.[22] We argue that it is far from certain that negotiating on a strong GIs regime is in the EU's *own* interests. During the last decade, the French wine sector has given ample proof that a strong GIs regime can be seriously damaging. Under the French strong GIs regime for wines, some French vineyards have performed well, but others very poorly. This suggests that "something else" than strong GIs is key to success in the modern wine business. Evidence from the last decade suggests that GIs alone have severe negative side effects, such as freezing the production technology, generating a cheating behaviour leading to overproduction, ignoring changes in consumers' tastes, among others. By contrast, success stories suggest that what counts is the existence of large wine companies (such as in Champagne) capable of meeting an ever changing demand while delivering the required level of quality and reputation via trademarks. The wine case should induce the EU to give up discussions on a strong GIs regime in the PCA (and in the Doha Round).

Services and investment: the "grand bargain"

In contrast to IPRs, European requests for more open services in China should attract support from Chinese consumers, because they raise the prospects of lower prices in services and/or more varied services. This is crucial because, although this agenda is based on economically sounder grounds than the IPR case, services liberalization in China faces several obstacles. First, China is the WTO Member which has agreed to the deepest services liberalization in the WTO context [Mattoo 2003]. This will render China rather reluctant to take bold initiatives in these matters in a bilateral context.

Second, services liberalization *per se* is notoriously difficult technically, as illustrated by the still very fragmented European so-called "Single Market" in services. Moreover, there is a systemic difference between liberalizing trade in goods and trade in services. In the former case, implementing liberalization is not costly. Dismantling tariffs does not impose administrative costs – on the contrary, it reduces them. By contrast, services liberalization generally requires new regulations that often induce implementation costs. In short, negotiating on services cannot be limited to a "give-and-take" approach such as for tariffs. It requires a thorough assessment of the associated costs, in order to pick those options which would minimize them.

Third, the trade distortions that a bilateral agreement on services between China and the EU would generate are hard to assess. On the one hand, such an agreement could generate massive trade distortions, hence very high costs, because most services are still very much protected. On the other hand, such costs could be significantly reduced if the investment rules in services to be included in the PCA are open enough to limit the discriminatory aspect of the EU-China bilateral agreement with respect to the rest of the world.

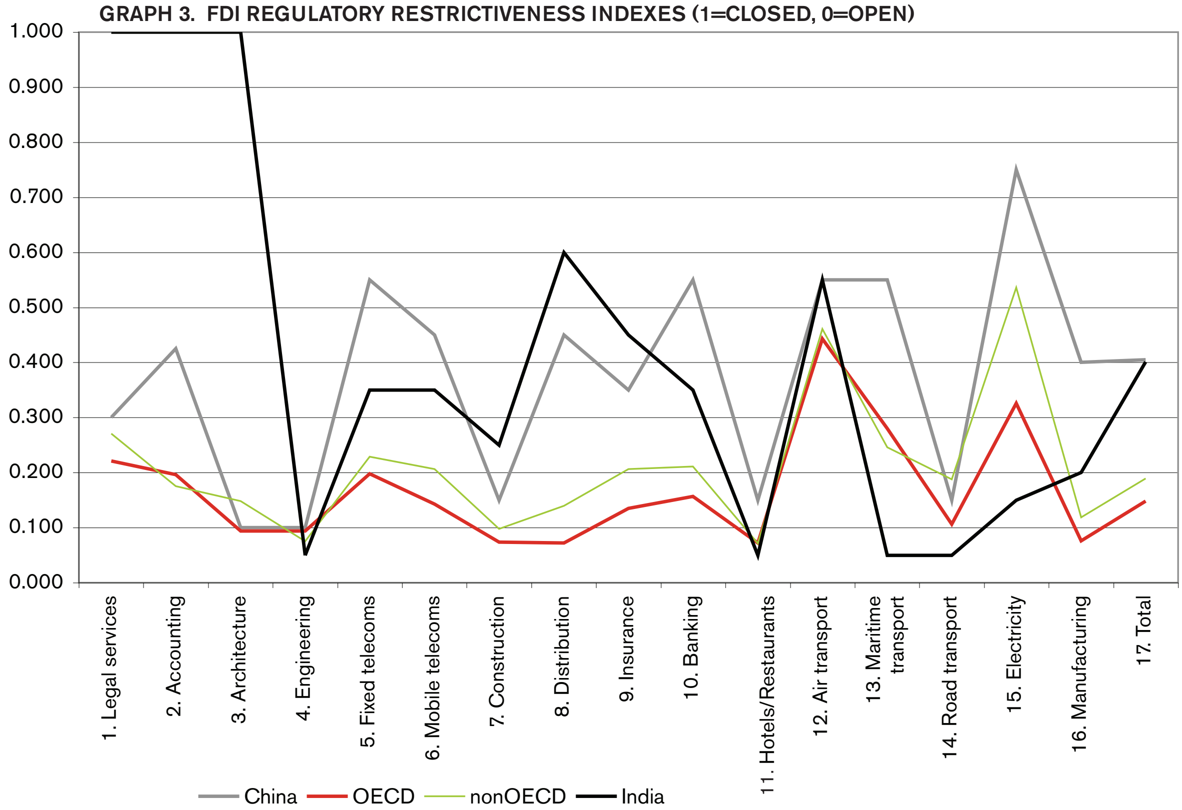
This last point suggests that the EU should focus on one aspect of services liberalization, namely international investment (hereafter, foreign direct investment or FDI) in services, where it seems easier to contain *de facto* or *de jure* the risks of discrimination. In addition, negotiations on FDI in services have a political advantage: as China has both important inward *and* outward FDI flows, there are opportunities of mutually beneficial concessions.

China's inward FDI

INVESTMENT REGULATIONS ARE the Achilles' heel of China's liberalization. China is one of the most attractive countries for FDI, but its restrictions on inward FDI are among the highest in the world, as illustrated by Graph 3 [Koyama & Golub 2006]. They are as high as in India, and much higher than those imposed by the other non-OECD countries included in the OECD study (Argentina, Brazil, Chile, Israel, Russia, and South Africa).

These restrictions are consistent with the fact that, although China is one of the largest recipients of total FDI among the developing countries, its FDI stock in percentage of its GDP and, more strikingly, its FDI stock per capita is relatively low, even when one focuses on the nine richest provinces which attract most of the inward FDI (see Table 4).[23]

GRAPH 3. FDI REGULATORY RESTRICTIVENESS INDEXES (1=CLOSED, 0=OPEN)



Inward FDI in services is a particularly attractive topic of negotiations in an EU perspective, since many of its economies are capital-abundant and services-oriented. Inward FDI in services would also be very attractive for China for three different reasons. First, it is a large net creator of domestic jobs in the host country. This is particularly true in China where it is hardly conceivable to operate services on a large scale without Mandarin-speaking employees. Hence, not only Chinese consumers but also potential Chinese employees of EU investors in services should be supportive of lower restrictions on inward FDI in Chinese services. Second, inward FDI would spur a kind of competition in services that is largely based on differentiation (services are almost endlessly differentiable), which offers a wide range of possible adaptation strategies for providers of Chinese services who are facing competitive pressures from European entrants. Last but not least, more variety in services would stimulate and deepen domestic Chinese consumption, which is also a key determinant of the yuan exchange rate. This would stand in sharp contrast to inward FDI in goods that stimulates Chinese production for exports, which magnifies trade frictions.

TABLE 4. FDI STOCKS, SELECTED COUNTRIES (2006)

	FDI stock in % total [a]		FDI stock in % GDP		FDI stock per capita	
	inward	outward	inward	outward	inward	outward
Argentina	1.9	1.5	27.4	11.2	1527.3	626.7
Brazil	7.0	5.4	20.8	8.2	1206.6	473.3
China	9.3	4.6	11.1	2.8	225.7	56.6
Top 9 provinces [b]	7.9	3.9	18.9	4.7	597.4	149.7
India	1.6	0.8	5.7	1.5	46.9	12.0
Indonesia	0.6	1.1	5.2	4.8	87.6	79.7
Malaysia	1.7	1.7	36.0	18.7	2152.0	1117.9
Mexico	7.2	2.2	27.2	4.2	2202.4	338.6
Russia	6.3	9.8	20.2	16.0	1374.2	1090.2
South Africa	2.4	2.7	30.2	17.1	1692.8	955.8
Thailand	2.2	0.4	33.0	2.7	1068.5	88.0
Vietnam	1.1	--	54.8	--	407.1	--
All selected countries	49.1	34.1	20.2	7.2	419.4	147.7

Sources: UNCTAD [2007], World Development Indicators [2007a].
Notes: [a] FDI stock in percentage of total FDI stock in developing countries. [b] estimates for the nine top Chinese provinces (see Table 2), based on the assumption that these provinces represent 85 percent of China's inward and outward FDI, and 50 percent of China's GDP.

Which Chinese services could be considered the best "candidates" for negotiations in the PCA context? The final choice will be a compromise between the EU's and China's respective preferred options. The EU would probably pick services in which Europe-based businesses believe they have comparative advantages. China's options are more complex. On the one hand, China's economic benefits would be the highest if it focuses on its most protected sectors. This is because, in services as in goods, the higher the restrictions, the higher the gains from market opening for the Chinese consumers of services. On the other hand, making the level of protection on inward FDI as uniform (non-discriminatory) as possible among all Chinese services sectors is politically difficult because it means targetting sectors which have been skilled and powerful enough at maintaining high protection, such as electricity, banking, telecommunications, air and sea transport (see Graph 3). However, interestingly, some of these sectors show signs of change, either in terms of regulations, such as banking (Deutsche Bank Research 2006b), or in terms of FDI, such as airlines.

China's outward FDI

Outward FDI is a mirror image of the crucial macroeconomic imbalances discussed in section 2, namely a high Chinese savings rate and a high U S consumption rate. A large inward FDI in China's industrial sector creates China's massive labor-intensive industrial exports which, combined with a very high Chinese domestic savings rate, generates massive reserves of foreign currencies. Until

TABLE 5. MAJOR OUTWARD ACQUISITIONS BY CHINESE COMPANIES (JANUARY 1999 TO JANUARY 2006)

Announcement date	Deal status	Acquired stake (%)	Bid value (Euro m)	Target name	Target domicile	Chinese bidder: Name	Chinese bidder: Legal status [a]
2001.06	Completed	100	1154	Hyundai Display Technology	Korea	BOE Technology	private
2002.01	Completed	86	672	Repsol-YPF (Indonesian assets)	Indonesia	CNOOC	SOE
2003.11	Completed	67	450	Thomson SA (TV unit)	France	TCL	private
2004.07	Completed	49	419	Sangyong Motor	Korea	Nanjing Auto	SOE
2004.12	Completed	100	1303	IBM (PC unit)	USA	Lenovo	private
2005.07	Completed	100	72	MG Rover	Britain	Nanjing Auto	SOE
2005.08	Completed	100	3204	PetroKazakhstan	Canada	PetroChina	SOE
2003.10	Pending [b]	13	593	Gorgon Liquefied Natural Gas Field	Australia	CNOOC	SOE
2005.06	Pending [b]	100	370	PetroChina International	Indonesia	CNPC, PetroChina	SOE
2006.01	Pending [b]	45	1894	Akpo oil filed assets	Nigeria	CNOOC	SOE
2005.05	Aborted	n.a. (100)	15255	Unocal	USA	CNOOC	SOE
2005.06	Aborted	n.a. (100)	1050	Maytag	USA	Hai'er	private

Source: Deutsche Bank Research 2006
Notes: [a] SOE: state-owned enterprise. [b] As of January 2006.

recently, China's reserves were largely invested in liquid assets (U S Treasury bonds). Today, roughly 70 percent of these reserves, which are managed by the State Administration of Foreign Exchange under the supervision of the People's Bank of China, are believed to be held in U S dollars, the rest being increasingly invested in higher-yielding assets. This Chinese outward FDI amounted to US$ 2.9 billion in 2002 and in 2003, 5.5 billion in 2004, 12.2 billion in 2005, and 16.1 billion in 2006. Table 5 lists the most important acquisitions by Chinese firms until January 2006.

Three specific Chinese acquisitions have attracted a lot of attention. In May 2007, China's new state investment agency acquired a US$ 3 billion stake (8 percent of the capital, with no voting rights) in the Blackstone Group, one of the world's largest private equity investment firms. In July 2007, Barclays Bank announced that China Development Bank, along with Temasek from Singapore, was ready to support Barclays' bid on ABN Amro (the attempted bid failed after the subprime crisis of Fall 2007). In the last days of December 2007, Morgan Stanley, after losses in the U S subprime mortgage crisis, announced that it would sell 9.9 percent of its capital (5 billion USD) to China Investment Corporation, which is one of the two Chinese Sovereign Wealth Funds (see below).[24]

China's outward FDI is largely driven by two so-called "sovereign wealth funds" (SWFs). The year 2003 witnessed the launch of China's official "Go abroad" policy, the allocation of a share of foreign exchange reserves to outward FDI by the China's State Council, the creation of the State-Owned Assets Supervision and Administration Commission (SASAC), and of the first SWF. The largest 161 state-owned enterprises (SOEs) have been affiliated to SASAC, with most of these SOEs enjoying preferential finance and insurance support from institutions such as China's Bank of Development. In 2007, China established a second SWF. As Table 6 shows, once merged, the two Chinese SWFs will make China's SWF one of the largest in the world, with roughly US$ 300 billion in assets.[25]

Investments by SOEs-based SWFs should cause no concern as long as they have the same incen-

TABLE 6. THE LARGEST SOVEREIGN WEALTH FUNDS, 2007

Country	Fund	AuM US$ billion	Inception	Origin
U. Arab Emirates	AbuDhabi Investment Authority	875	1976	oil
Singapore	Gvt of Singapore Investment Corporation (GIC)	330	1981	non-commodity
Norway	Government Pension Fund of Norway	322	1990	oil
Saudi Arabia	(various funds, na)	300	(na)	oil
Kuwait	Kuwait Investment Authority	250	1953	oil
China	China Investment Corporation	200	2007	non-commodity
Hong Kong	Hong Kong Monetary Investment Portfolio	140	1998	non-commodity
Russia	Stabilization Fund of the Russian Federation	127	2003	oil
Singapore	Temasek Holdings	108	1974	non-commodity
China	Central Hujjin Investment Corporation [a]	100	2003	non-commodity
Australia	Australian Government Future Fund	50	2004	non-commodity
Libya	Reserve Fund	50	(na)	oil
Qatar	Qatar Investment Authority	40	2000	oil
US-Alaska	Alaska Permanent Reserve Fund Corporation	40	1976	oil
Brunei	Brunei Investment Agency	30	1983	oil
Ireland	National Pensions Reserve Fund	29	2001	non-commodity
Algeria	Reserve Fund	25	(na)	oil
Korea	Korea Investment Corporation	20	2005	non-commodity
Malaysia	Khazanah National	18	1993	non-commodity
Kazakhstan	Kazakhstan National Fund	18	2000	oil
Canada-Alberta	Alberta Heritage Fund	17	1976	oil
Taiwan	National Stabilisation Fund	15	2000	non-commodity
US-Mexico	New Mexico State Investment Office Trust Funds	15	1958	non-commodity
Iran	Foreign Exchange Reserve Fund	15	1999	oil
Nigerai	Excess Crude Account	11	2004	oil
New Zealand	New Zealand Superannuation Fund	10	2003	non-commodity

Source: Deutsche Bank Research, September 10, 2007.
Note: [a] This SWF should be merged with China's other SWF.

tives as private firms such as upgrading products or technologies, ensuring access to essential natural resources for the firms, tariff-jumping (particularly in goods subject to repeated antidumping or safeguard measures, such as textiles, cycles or TV sets), generating assets for the future (a key goal of the many oil-based or natural resource-based SWFs) etc. Indeed, few concerns have been heard for the many SWFs listed in Table 6, despite the involvement of domestic public authorities and despite the fact that transparency is hardly the latter's main virtue.

That said, public ownership of Chinese SWFs raises two problems, one for China's partners, and one for China itself. The fact that there are *two* problems, not one, happens to be a key opportunity because it offers a window of opportunity for joint granting of benefits from both sides.

The most frequent problem of concern for China's partners is where the assets targeted by the SWFs originate. SOE-based SWFs go against two decades of privatizations undertaken in the market economies. These privatizations have often been hard to decide upon. It was not easy to convince the public that privatization in a market-driven context was more likely to ensure a more efficient allocation of resources in the long run than public enterprises. It is also hard to achieve successful privatizations. Privatized companies have often maintained anti-competitive features from the former public enterprises and have continued to operate under very imperfect competitive conditions: in short, private quasi-monopolies have sometimes replaced public monopolies, with no gains for consumers. Acquisitions by SOE-based SWFs could endanger the slow and long efforts, and potentially lead to some kind of "re-nationalizations" under the influence of powerful foreign governments.

SOE-BASED SWFs RAISE another problem, which is much less discussed, but that is of concern to China itself. Like all SOEs, Chinese SOEs are plagued with many distortions, such as subsidies, public capital, managed prices, unaccountable management, non-transparent decisions, political interference, etc. The problems that Chinese SOEs will raise in a *Chinese* perspective can be easily predicted by looking at their close cousins, the EU's SOEs. EU SOEs have a long track record of costly and/or unsustainable foreign investments. To mention a few cases: France Telecom, Crédit Lyonnais, Westdeutsche Landesbank, and Landesbank Sachsen, among others. This was often combined with relative disinvestment in domestic markets, such as was the case with Electricité de France. In short, the costs of outward FDI from SOE-based SWFs may be huge for Chinese taxpayers, which was already highlighted by the Blackstone case.

As a result, *both* China and its partners have strong interests to unite in finding satisfactory solutions for dealing with SOE-based SWFs. This is crucial because the "unilateral" solutions put in great haste by China's trading partners are, by nature, not optimal. In 2007, the U S adopted a law enhancing government scrutiny of proposed sales of critical infrastructure businesses to foreign government-controlled entities via the newly-created Committee on Foreign Investment in the United States (CFIUS). Similar laws which have been passed in France, are in the process of being passed in Germany and other EU Member States, as well as in Canada. A a similar law is even envisaged by China. All these laws include, almost inevitably, language that is loose enough to open the possibility of discriminatory decisions. In short, they are bound to be a back door to protection of domestic assets against foreign capital.

What might, then, be the solutions? First, China and the EU could improve the situation by working on their *own* economies. The PCA discussions even offer an opportunity for China and the EU Member States to exchange views on what they could undertake on that front. For China, privatizing SOEs *and* introducing appropriate regulatory reforms in the targeted markets are key components of such a solution [He 2007]. For the EU, and perhaps surprisingly at a first glance, improving the functioning of its own domestic Single Market is an equally important part of the solution. In a nutshell, the larger and the more competitive the European markets will be, and the more unified the Single Market, the lower the risks of distortions generated by SOE-based

SWFs. For instance, potential EU-China clashes on energy could be reduced if the physical interconnections of the EU domestic energy markets are improved, allowing an optimization of the EU's energy policy options.[26] Similarly, deepening the Single Market in financial services would alleviate the fears raised by China's SWFs in this particular sector.

Second, given that such domestic reforms in China and in the EU Member States require time to be achieved, the PCA should address shorter term issues by offering the opportunity to negotiate joint procedures for solving problems raised by outward FDI in the short or medium term. It should be taken for granted that such procedures include outward FDI by European SOEs. For instance, China and the EU Member States could decide when and how to involve in these procedures institutions that are seen as neutral, knowledgeable, and trustable by both sides, such as the Bank of International Settlements (probably the institution preferred by the bankers), the IMF, the World Bank or even the OECD, as recently suggested by the U S Administration.

Boosting the chances of a "grand bargain" in the rules agenda

The above discussions strongly suggest that the EU should prioritize its liberalizing requests in the PCA context on China's most protected services, such as electricity, banking, air and sea transport, and telecommunications. The EU could target a few of these sectors, and consider others, less obvious but promising, such as the health sector for which anecdotal evidence shows a potentially huge Chinese demand (Tsai 2008). Such EU requests are likely to find support in China, by consumers or potential employees in those services alike, and they might even receive support from the Chinese authorities to the extent that they alleviate China's current macroeconomic imbalances.

What are the concessions that the EU could offer to China? Of course, Europe could open its own services markets more. However, such an offer may have limited attractiveness for China because, in the short or medium term, not many Chinese services providers may benefit.[27]

What could, then, be the additional concessions that would boost the chances of a "grand bargain?" First, as mentioned above, the EU should propose to establish joint procedures for dealing with the difficult cases of China's outward FDI. Second, as discussed below, the EU should create procedures for dealing with the norms and standards conflicts in industrial and agricultural products.

Second, the EU could offer an earlier, progressive renunciation of the use of Section 16 of China's Accession Protocol which establishes a "transitional product-specific safeguard" (TPS). The TPS is a pending threat to China's exports, particularly in case of a serious world recession. In a nutshell, the TPS makes it legally very easy for a WTO Member to impose safeguard measures against Chinese exports until 2014. Moreover, as soon as one WTO Member imposes a TPS measure against Chinese exports, the other WTO Members could enforce a similar measure at almost no cost in terms of legal procedures. In short, keeping Section 16 untouched while receiving market-economy status in antidumping procedures may well be a Pyrrhic victory for China.

The EU may therefore offer not to use the TPS for goods (or sectors) that would meet certain criteria to be agreed with China in the PCA negotiations (Messerlin 2004). First, Chinese tariffs on the goods to be exempted from the TPS should be low enough (say less than 10 percent) to ensure that the Chinese markets of the products or sectors in question are well disciplined by world markets. Second, a well-defined core set of China's non-tariff barriers on these goods should be eliminated or reduced. Lastly, not using the TPS could be made conditional on the opening up of the services sectors associated to the products in question. For instance, this condition could mean the elimination of distribution monopolies (be they state-owned or private) in China and the opening up of critical services to inward FDI.[28]

Last but not least, the EU and China would derive huge benefits from shaping a WTO-compatible outcome of their PCA negotiations on the behind-the-border agenda. It is beyond the scope of this paper to elaborate on how to give a multilateral dimension to the EU-China provisions on investment in services. Such an effort would be made easier if the WTO negotiations in these matters would adopt a "plurilateral" approach based on the WTO Members willing to liberalize faster than the rest of the WTO membership states rather than a rigidly multilateral approach (Messerlin 2007).].

Subsidies, government procurement, norms and standards

The EU's list of important topics under the PCA's behind-the-border agenda also includes subsidies, government procurement, and norms and standards. It seems unlikely that the PCA negotiations could go very far for the two first items, for two reasons. Subsidies is a topic that cannot be handled meaningfully in a bilateral context – by nature, they imply a multilateral framework of negotiations (one cannot subsidize with respect to some markets, and not with respect to other markets). Negotiating on public procurement is hard to do without involving "sub-central" authorities (provinces and towns are often more important in this field than central authorities).

Norms and standards are a different matter. They are likely to be the bread and butter of EU-China negotiators for a long time to come. This should not come as a surprise to Europeans, since these issues remain a permanent source of differences and frictions within the EU. It also helps to understand the massive crackdown undertaken by the Chinese authorities which closed the business of almost three thousand rural food suppliers late 2007. That said, the EU can expect to have a hard time making its complaints heard about Chinese norms as long as the world is still waiting for the scientific evidence of the decade-old EU ban on hormones-raised beef or GMOs.

The last months have witnessed an unpleasant turn in the area of norms and standards. Unsafe Chinese exports (particularly, in toys) have particularly appeared in the limelight. There are two ways to address such issues. First, the PCA could establish closer co-operation between China's and EU's safety bodies. Such an option seems to have been adopted by the last China-U S ministerial meeting (Inside U S trade, December 14, 2007). Taking the same approach would be a strong motive for the EU and the U S to adopt increasingly similar procedures. This would also be beneficial to the rest of the world.

Second, reports on unsafe Chinese products have been done without any comparable tests on competing products sold in the EU, be they originating from the EU or from other countries than China. The EU should make clear that the same tests revealing flaws in the safety of Chinese products are to be imposed equally and immediately on competing EU products or imports from countries other than China. This rule would reduce the risk of norms and standards being used as a protectionist device, while it would reinforce the EU's position with respect to China in these complex issues, not to mention the position of the Chinese government with respect to its own exporters.

SECTION 4. FROM TRADE TO FOREIGN POLICY

In several instances, the EU has tried to instrumentalize its trade policy as a foreign policy. Africa is the first illustration of such efforts in the Community's early years, and Asia the latest. Both cases are of prime interest for EU-China trade relations.

Africa and the developing countries

The economic decline of many African countries since the 1970s has rendered less visible the foreign policy aspect of the EU trade policy. But China's rapid emergence in Africa has given it a central position once more. In November 2006, China made its strategic views on Africa explicit by hosting the first China-Africa forum, echoing the growing trade and investment flows coming to Chinese firms in Africa and the opening of China's huge and booming cotton market to African exports. Africa, and most notably countries such as Angola, Sudan and the Democratic Republic of Congo, are particularly rich in those raw materials ranging from oil to wood to cotton needed by Chinese industries. This makes China a supporter of an immediate duty-free, quota-free treatment of products from the least developed countries (Wang 2008).

In the first years of the Doha Round China opposed the EU's proposal of a "Round-for-free" for the least developed countries (LDCs), many of them being located in Africa. Pascal Lamy, then Trade Commissioner, tabled this notion largely in order to gather LDC support for EU positions. From an economic point of view, a Round-for-free is costly for the LDCs, which badly need so much to open their markets, admittedly in a careful way, in order to reap all the possible gains they can from freer trade. But, from a political point of view, a Round-for-free was attractive for African countries reluctant to liberalize.

Its initial opposition to a Round-for-free put China in an uncomfortable position in the WTO. While the Chinese position was providing the economically sound option that would support much-needed long term reforms in the LDCs in order to accelerate growth, it was running against the positions of LDC officials who enjoyed the diplomatically and domestically comfortable inertia offered by the Round-for-free proposal. Ultimately, China came back to the usual rhetoric of the developing countries when leading the so-called "G33". This coalition of WTO Members aims to limit, as strongly as possible, market access to developing countries through the notions of "special" products and "special safeguard mechanisms."

The last months of 2007 witnessed the EU Commission's efforts to bully African-Caribbean-Pacific (ACP) into concluding Economic Partners Agreements (EPAs), which are meant to replace the former EU-ACP agreements (Delpeuch 2007). Initially, EPAs were supposed to open the ACP markets to EU products *as well as* to create regional free trade areas among ACP countries. Regional liberalization was presented as critical because it was argued that it would mitigate the negative consequences of opening the tiny ACP economies to EU producers.

The uncompromising stance of the EU Commission late 2007 blew up this initial plan. First, as of early January 2008, only 35 ACPs (out of 78) have initialed a full EPA or a more vague "interim agreement." Second, the vast majority of the signed agreements are *de facto* or *de jure* bilateral (that is, between the EU and each individual ACP country), making a mockery of the key argument of African regional integration. While it remains to be seen how the situation will evolve in 2008, the major reason that has driven the EU Commission's hard line seems to be the desire to give to EU firms a strong preferential access to ACP markets, comparable to the access enjoyed by firms from China and from other WTO Members.[29] Such a goal may be justifiable from a purely EU-centric, short-sighted, trade perspective. But it clearly magnifies trade distortions in the ACPs, and hence it has strongly negative effects on ACPs long-term development, with political consequences easy to predict.

Asia and preferential trade agreements

The second illustration of EU trade policy as a foreign policy is given by the proposed preferential bilateral trade agreements (hereafter, "bilaterals") with a certain number of Asian countries. In November 2006, the Commission tabled a working document suggesting the negotiations of a large number of bilaterals (24 including the PCA with China). This was an important change of course in European trade policy strategy away from multilateralism and towards bilateralism.

From an *economic* perspective, these initiatives are leading both the EU and China into dangerous waters. In sharp contrast to the bilaterals under negotiation or consideration by five other countries (Chile, Japan, Korea, Singapore and the U S) the bilaterals envisaged by the EU (and China) are characterized by an initially highe level of tariffs and/or non-tariff barriers in goods, and by restrictive regulations in services and investment (Messerlin 2007). Economic analysis shows that such preconditions are likely to generate strong distortions in trade and investment flows when the bilateral comes into force, to the detriment of the European and Chinese consumers in the short run, and of the European and Chinese producers in the long term.

From a *political* perspective, a bilaterally-based policy appears to be a major strategic mistake for the EU. First, one may wonder how the EU trade negotiators will be able extract more concessions from a *tête-à-tête* with China, when they have been unable to do so in the WTO multilateral forum during the Doha negotiations. By contrast, a trade policy based on bilateral agreements in Asia is familiar to China's diplomacy – it echoes the Chinese imperial tradition dating back to the Tang and Ming dynasties, when trade agreements were instrumental for the recognition of the political supremacy of Chinese emperors.

Second, a policy based on bilaterals will almost inevitably generate severe *intra*-EU tensions. For instance, a bilateral with, say, Korea may open the Korean insurance market to a given EU insurer. However, this EU insurer may have preferred a preferential market access to (say) Indonesia, and he will be unhappy when an EU competitor will be chosen for entering the Indonesian insurance market, once the EU will have concluded a bilateral with Indonesia.

Last but not least, the EU's focus on bilaterals is likely to raise incentives among Asian countries to negotiate bilaterals among themselves, risking by the same token to marginalize further the EU. One could argue that Asian countries may not need such an additional incentive, and that they may be heading to an Asian Economic Area anyway, as Europe did fifty years ago. However, any parallel drawn between Europe and Asia underestimates the differences in initial conditions behind the European and Asian endeavours. First, trade between the EU founding Member States *before* the EU creation was different – in nature and depth – from the current trade between the Asian countries (Kang 2008). Second, even more crucially, Asian countries do not enjoy the very special political situation that has characterized the EU's endeavour since its inception, namely the fact that the large Member States have always had a roughly similar economic size. In other words, there was no serious threat of supremacy of a large European Member State over the others. This is definitively not the case in Asia. Indeed, the enormous asymmetry in terms of size among Asian economies could only make most Asian countries prefer to see the EU (and other non-Asian countries) maintaining a multilateral approach to trade issues, because it is their best guarantee of economic and political independence.

CONCLUDING REMARKS

This paper has discussed means to renew and recalibrate the current EU trade policy strategy towards China. Since 2006, the EU has adopted a bilateral approach and proposes a Partnership and Cooperation Agreement involving the renewal of the agreement concluded by both parties in 1985. The EU's stance towards China has become confrontational at the end of 2007, a strategy that will prove to be counterproductive and damaging. This paper proposes an alternative approach to leading talks with China within the context of the PCA: a working strategy for the EU should involve promoting EU interests while attracting support from Chinese interests. The main proposals are:

- In trade in goods, achieving a genuine dialogue with China would involve a "*small bargain*." The latter would consist in a better joint enforcement of China's WTO Protocol Accession: the EU would grant China market economy status in anti-dumping, and China would improve implementation of its tariff schedule.
- In the behind-the-border rules agenda, the EU-China Partnership and Co-operation could develop a "*grand bargain*" focusing on the following issues:

    - A reduction of China's highest barriers on inward FDI in services.
    - An improvement of Chinese access to EU services, with the EU renouncing its right to use the special safeguard included in China's WTO Accession Protocol (Section 16).
    - A joint setup by the EU and China of procedures to address the concerns raised by some of China's Sovereign Wealth Funds' operations and by some EU norms and standards.
    - An important cut in Europe's requests on other issues, in particular on intellectual property rights.

- The EU should review its current initiative on *bilaterals* (in particular, with Asian countries) and re-focus its trade policy on the WTO. Even China would benefit from such a re-balancing. Progress in the WTO would contribute to the emergence of a "Chinese Single Market," whereas bilaterals would favour a deeper segmentation of Chinese provincial markets. The forum provided by the WTO is a buffer for conflicts that bilaterals tend to re-activate, sooner or later.

Such an ambitious EU trade policy towards China has two crucial implications on EU *domestic* affairs. The first is *economic*. A powerful way to minimize the concerns raised by China's competition is to improve the functioning of the EU Single Market. This involves a much higher degree of interconnection between the still fragmented European markets, particularly in services, in order to make these markets larger and more competitive. There is a symmetrical challenge for China as well, namely to continue to improve the functioning of its own domestic markets by deepening liberalization and privatization, and, above all, by generating the institutions required by a sustainable market economy.

The second development is *political*. The behind-the-border agenda (services, investment, norms, etc) involves deeply the EU Member States. As a result, the EU negotiating machinery as currently designed, with its almost exclusive reliance on the Commission's negotiating capabilities, is not efficient. Indeed, it generates much frustration among the EU's large trading partners, including China, which do not know whom to talk to. There is therefore a strong need to review this machinery. Delving into this issue in detail goes beyond the scope of this paper. An important option to consider is, however, direct participation of the EU Member States in the negotiating teams dealing with those behind-the-border issues crucial for them.

A truly global approach

Such an ambitious program has no chance to succeed if it does not fulfill two conditions: to remain focused on economic initiatives, and to involve other major economies in the process of trade policy dialogue with China. First, it should keep a clear economic focus. In the PCA context, the EU Commission has gone way beyond economic issues. For instance, the paper "Closer partners, growing responsibilities" mentions the need "to leverage the potential of a dynamic relationship with China *based on our values*" (authors' italics) and it tackles political issues such as China's transition towards a more open and plural society or human rights, etc. Europeans should not be silent on these issues. But such goals should be handled by the Europeans at large (governments and civil society), not by their trade negotiators.

The second condition is that the EU should combine its actions with other players in the world. It would be foolish for Europe to believe that it can act alone. Mimicking the U S-China "*tête-à-tête*" initiated by the current U S Administration would be a frivolous exercise. Europe does not have the same broad political interests nore the vast means for their action as the U S. Aligning to the U S positions, as *de facto* done by the Commission since October 2007, is not useful for the EU, nor is it for the U S. As shown in this paper, an aggressive focus on the EU-China trade balance is counter-productive for a vast majority of EU Member States, from those quietly improving their exports to China to those having chosen a clear trade specialization. The EU's support for a rapid yuan realignment runs serious risks. This includes appearing inconsistent when combined with the silence on the imbalances within the eurozone or on the U S dollar slide, or ignoring the worldwide consequences of a possible severe downturn of the Chinese economy after the current Olympic Games boom. In fact, an EU-U S "gang" on this issue is largely counter-productive for the U S position to the extent that it will almost inevitably reinforce the protectionist camp in Beijing, and sideline the supporters of such a realignment in China.

Therefore, the EU would be best serviced by trying to co-ordinate its actions and co-operate with a broader group of countries, not only with the U S and Japan.[30] This is a daunting task. However, beyond many well known differences, Europe shares some key similarities with China that could be helpful for such an endeavour. Europe and China have both immensely suffered during the XXth century – from civil wars to costly economic and political mistakes. And, for the decades to come, they will face the same crucial challenge – how to define the best balance between the "central" and "local" authorities in such deeply heterogeneous and very large economies.

The way forward is to involve medium-sized countries, such as Australia, Korea, or Chile. The advantage that this would bring is that these countries are often among the best performers in domestic governance. They innovate faster and better in terms of economic regulations. Not only would their experiences be most useful, they would also make it politically easier for Chinese interests eager on such best practices required by a well-functioning market economy to promote its adoption in China.

As often in critical periods, the past can provide inspiration for the future. No other political figure would be better suited to be invoked in this context than Cordell Hull, the U S Secretary of State from 1933 to 1944. At a time when such policies were considered foolish, he provided the much needed foresightedness on trade issues and was the architect of the U S's contemporary open trade policy, as well as of the GATT, the predecessor of the WTO. He also was the U S State Secretary who delivered the treaty that abolished U S extra-territorial rights in China, closing the doors on a century and opening the doors to a new century – our century.

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FOOTNOTES

1. We would like to thank very much Max Corden and Tony Miller for their very insightful comments and suggestions, and the participants to the ECIPE conference "Stepping into Asia's Growing Markets", Brussels, November 6, 2007.
2. The U S has faced a similar challenge in the aftermath of the Second World War. Interestingly, the U S is still 15-25 percent richer than Europe (on a per capita basis). On the other hand, the EU may, in several respects, face a challenge closer to the one that China faced in the XIXth century.
3. Bound tariffs cannot be raised without compensating the affected trading partners (or running the risk of retaliation). By contrast, an applied tariff lower than the corresponding bound tariff can be raised up to the bound level with no consequence for the country.
4. The current members of the G20 coalition are: Argentina, Bolivia, Brasil, Chile, China, Cuba, Egypt, Guatemala, India, Indonesia, Mexico, Nigeria, Pakistan, Paraguay, The Philippines, South Africa, Tanzania, Thailand, Uruguay, Venezuela, and Zimbabwe.
5. PPP estimates for China are subject to considerable debate after the recent release of new (preliminary) calculations by the World Bank cutting by no less than 40 percent the exchange rate used so far by the World Bank (World Bank 2007a, 2007b). The difference in these estimates is largely related to the difficulty to get hold of good estimates of the price level in rural China, in contrast to urban China (indeed, it would be interesting in our exercise to use different PPP rates for mostly rural and mostly urban Chinese provinces). That said, in a decade from now, the current growth differential between China and the EU would make Table 2's lower estimate similar to Table 2's higher estimate.
6. The ATC expired on December 31, 2004, only a few months before the EU safeguard against China. It gave EU producers ample time – ten years from 1994 to 2004 – for adjusting to increased competition from developing countries (Francois & Woerz 2006).
7. Antidumping and safeguard cases have been extensively analyzed by a host of economists and lawyers, for instance, see Bloningen & Prusa (2003), Mavroidis et alii (2008). Less than 5 percent of all the EU and U S cases in the 1980s and 1990s would ultimately make economic sense from a competition policy point of view (Bourgeois & Messerlin 1998, Shin 1998).
8. Indeed, these measures have generated many tensions among the EU Member States, with an increasing opposition from the Member States where businesses have adjusted to modern commerce practices. These tensions have been made public by a joint op'ed signed by four EU Trade Ministers, a rather unusual initiative (Gennip *et al*, 2005).
9. The number of Chinese antidumping cases against EU products per US$ billion of imports of Chinese imports from the EU has slightly increased from 0.041 (1995-2001) to 0.049 (2001-2005) actions. However, the stock of China's antidumping measures in force in 2006 per US$ billion of Chinese imports from the EU (0.140) is only half the stock of EU antidumping measures in force per US$ billion of EU imports from China.
10. The Chinese government's reply to EU's trade defence instrument questionnaire mentioned that: "The trade defence measures have even become tools for unfair competition by some multi-national companies. They make investments and profits in the exporting countries. Meanwhile, they apply for trade defence measures in the importing countries targeting products originated in the exporting countries with an objective to carving up different markets to pursue monopoly, which should not be tolerated."
11. In addition to the analytical issues examined in the text, China's trade statistics raise serious problems, largely due to the role of Hong Kong as a services center for goods produced in the PRC, and the "triangular trade" between two Chinese provinces via Hong Kong-based serivces (WTO 2005). The importance of the capital flows between the EU and the U S partly explain the changes in trade shares.

12. Dean, Fung & Wang (2007) estimate that roughly one third of China's exports to the world is attributable to imported inputs, with a "vertical" specialization exceeding 50 percent in some sectors, and growing over time.

13. Graph 2 excludes imports from OPEC members in order to leave aside oil imports as much as possible. In its note on "China in international trade" (website 11 June 2007) the European Commission provided a similar graph and made the appropriate observations ("most of the products exported from China are assembled from parts made somewhere else, in Asia, Europe or the US ... China is replacing other Asian suppliers of developed countries") without drawing the logical conclusion for designing the EU trade policy.

14. At this stage, it is necessary to mention the flawed argument that the Commission is repeating *ad nauseam* – the fact that the EU exports more to Switzerland than to China. It simply mirrors proximity (Germany exports to Austria 70 percent as much as to France) and time (wait for China's economy to become be larger…).

15. China has cut tax rebates on 2,831 types of products from July 1, 2007, and has introduced export taxes on steel in December 2007. Export taxes and import subsidies are very imperfect substitutes to a market-driven currency re-alignment. They are costly because they are discriminatory – they favour some products to the detriment of others, creating "artificial" winners who then try hard to keep the status quo, opposing further adjustments of the economy, hence triggering speculative shipments from traders and decisions from other firms.

16. The reference to the sharp and fast appreciation of the Taiwanese dollar in the mid-1980s as an illustration of what could be done misses many aspects of the current situation, if only the size of China in the world economy.

17. The EU assesses the MET with five criterias: (i) does the government influence the company's operations? (ii) does the legacy of the plan economy, in terms of public ownership, barter trade, etc, affect the firm? (iii) does the firm operate under an effective company law, and does it have decent accounting standards? (iv) does the firm operate under an effective bankruptcy framework and property rights protection? and (v) does the firm convert currency at standard market rates?

18. In 2006, the Chinese Trade Ministry pushed for a regulation permitting Chinese exporters to petition against their Chinese competitors exporting at "unfairly low prices." This regulation was abandoned because of the fear that foreign firms established in China could use such a regulation to their own benefit.

19. Why such a length and wide scope? The EU negotiators often believe that piling up topics would make easier a final trade-off. Such a tactic has proven consistently disappointing, as best illustrated by the unceremonious abandonment of the EU-sponsored "Singapore issues" (such as trade and competition) in the Doha negotiations. The other explanation is the current dis-organization of the European negotiation structure, torn apart between the Commission and the Member States (see the text).

20. Social Security authorities of some EU Member States have begun to publish lists of drugs with "no notable" effects, and to delete these drugs from the lists of drugs benefiting from reimbursement. Moreover, some EU firms have taken initiatives self-limiting their IPRs, as best illustrated by the Sanofi-Aventis commitment to sell a new malaria drug (developed in collaboration with the DNDi foundation) at cost (Sanofi-Aventis 2005).

21. Indeed, the wide income differences in China give an interesting twist to the IPR debate. In the mentioned study (Emerging Market Groups, Study 12, 2007) several EU firms clearly do not consider as an "intellectual property right" the fact of simplifying a product and selling it at a much lower price than the initial European machine. In a strict sense, one could conceive patents on "simplified" products which could be exported to poorer Chinese regions, and possibly to the rest of the world, including the OECD countries.

22. Why then such an EU insistence? Topics may be tabled simply because they were part of previous negotiations – inertia haunts trade negotiations. The EU interest in GIs dates back from the Uruguay Round. It was driven by the will to compensate EU farmers for liberalization in agriculture – an awkward justification since GIs involve more the food processing industry than the farmers *per se.*

23. Table 4 relies on data of FDI in goods and services. But there is no reason to believe that FDI in services differs much from global FDI.

24. This investment is the third of this type and size: Singapore's SWF (Temasek) invested 5 billion USD in Merrill Lynch and an undisclosed amount in UBS (with an unidentified Middle Eastern investor), and Abu Dhabi's SWF invested 7.5 billion USD in Citigroup. These investments are probably not the last ones.
25. Altogether, SWFs represent 2-3 trillion US dollars in assets, more than all the world's hedge funds combined, but yet a tiny (though fast growing) share of the world financial assets estimated to 180-200 trillion US dollars.
26. A substantial increase of the competitive nature of the EU energy markets may offer attractive alternatives to the current EU energy-saving programmes that are burdened by a host of technical details which risk to further distort and weaken competition.
27. Once again, one should be cautious on such statements. As shown in section 1, China has already developed provincial economies that could be quickly, if it is not yet the case, able to support sophisticated services exporters, as illustrated by emerging retailing services in the textile and clothing sectors.
28. Paradoxically, Chinese state-owned sole *producers* are much more acceptable because, as shown by economic analysis, a protection granted exclusively by a moderate tariff to such firms eliminates the risk of monopoly power of the domestic sole producer.
29. "Margins of preference" (the difference between the bound tariffs to be paid by non-EU exporters to the ACPs and the zero preferential tariffs to be paid by the EU exporters to the ACPs) would be roughly 25-30 percent on average, and could go up to 100-150 percent.
30. Of course, almost all the EU actions should involve the U S [Atlantic Council 2007] and Japan simply because their huge economies cover all the possible topics of interest for the EU and China. The role of Japan is often under-estimated. For instance, large-scale initiatives in Africa could not be launched without Japanese support, if only because the Japanese Exim Bank is the third largest export credit agency in Africa, with almost US$ 9 billion, compared to China Exim Bank (almost US$ 16 billion) the US Exim Bank (US$ 14 billion) and the Britsih Exim Bank (roughly US$ 4 billion).

ANNEX A: ON THE THREE CHINAS

The map below visualizes the three different groups of provinces that can be defined on the basis of provincial GDPs per capita. It also illustrates the emergence of a Southern Chinese regional economic bloc around Hong Kong as a counter-balance to Shanghai's influence.