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Facing China

Building blocks of a comprehensive European (trade) strategy on China
Working Paper

Introduction

The political agreement on the Comprehensive Agreement on Investment between the EU and China in late December 2020 led to the realisation inside the EU that while the union has engaged with China for decades, it has so far shied away from conclusive discussions on a comprehensive European China-strategy. For better or worse, this discussion is taking place now, against the backdrop of the concluded investment agreement, long-standing concerns in the business community of unequal treatment, discriminatory behaviour and distorting government interventions, mounting concerns over the Chinese Communist Party's handling of Hong Kong and the human rights situation in Xinjiang as well as aggressive rhetoric and actions against politicians, journalists and think-tankers critical of the Chinese government.

The relationship is shaped by imbalances but more importantly very different perceptions of the world we live in and the bilateral relationship as such. For the majority of actors in the European Union, China is first and foremost an economic actor. For some this means an imperfect market economy, for others an economy dominated by the state, i.e. the Communist Party of China. Either viewpoint however allows the EU to form its engagement with China on a basis dominated by economic interests. This is also the lens through which the EU has tried to interpret Chinese actions, a viewpoint which is becoming less and less able to capture and explain what we observe.

For China, the relationship with the EU is much more than purely economic or dominated by these interests. It is a way to achieve its geopolitical and domestic goals, and its actions must be seen against this backdrop. The adoption by China of three key instruments in the recent past, the unreliable entities list, an export control law, and a "blocking statute", underline the priority China attaches to safeguarding its political and economic interests against those of other states. There are of course other, at times less tangible, means through which China acts in defence of its own interests: the weaponisation of trade to counter Australia's calls for an investigation into the origins of COVID-19, campaigns to spread disinformation, e.g. on the situation in Xinjiang and attacking those who call for investigations into the region, "spontaneous" boycotts of western brands which are part of the better cotton initiative and the exploitation of cyber vulnerabilities in third countries.

These observations underline the complexity of the relationship and how the same action will almost inevitably be conceived in very different ways in Brussels and Beijing. In many ways, it seems that the EU needs to face the harsh reality that it has misinterpreted or neglected the underlying factors for China's engagement with the rest of the world in the last years and must now scramble to formulate an answer. It must find policy space based on an agenda that pays heed to human and labour rights as well as environmental standards, while at the same time pursuing its economic and wider foreign policy agenda.

The track record of international cooperation with China is not as black and white as some commentators like to suggest. The early years of China's WTO membership point out the positive effects of cooperation, marked e.g. by liberalising reforms and standard modernisation at national level. But the observation that these reforms did not trickle down to the subnational level and were eclipsed by the pressures of economic growth as well as rising state interventionism in the last years underline the enormous task of reforming the Chinese economy and the strength of forces pursuing nationalist agendas. Cooperation will surely not satisfy those who expect China to embrace a market-led economic model. But results can be delivered nonetheless, through external pressure and other means, by creating an environment conducive to supporting a domestic reform agenda.

Following these observations, we conclude that isolation and a purely confrontational approach will lead to further escalation, entrenched positions, empowerment of nationalists and conservatives and ultimately a lose-lose situation. A scenario in which both economies have fully decoupled or are striving towards such a state will be excluded from the discussion. At the same time, it should be clear that the status-quo of the relationship and its trajectory are neither satisfying to the EU nor sustainable. Access to markets is too unbalanced, European companies and organisations are facing discrimination, overt and covert, which is clearly not reciprocated. Furthermore there are worrying signs of coercive behaviour of the Chinese government towards decisions taken on EU or member state level. The EU is increasingly finding itself in situations in which it simply has no means to react to Chinese actions.

It should be evident that no single instrument or agreement can capture the complex nature of the relationship and cater to all its inherent ambitions, challenges and concerns. Rather, a comprehensive mix of cooperative and unilateral elements, geared towards a common set of goals, is needed. This common set of goals, shaped by how the EU pictures the medium-term form of the relationship, will be as important as the instruments needed to achieve them.

It will be ever more crucial for the EU to retain the full flexibility to take decisions according to its own interest, be they regulatory or of other nature, to ensure that its own market access commitments are by and large reciprocated, to ensure that its value-chains remain functioning and dependable, and that they are designed in a sustainable and fair way and that it is able to stand up and defend a rules- and value-based global order. Today, none of these objectives are safely fulfilled.

An assessment of the current state of play and the EU's "toolbox" leads us to the following observations and demands:

A) **Cooperative elements**

There are numerous existing and potential elements of a cooperative nature, which form part of the bilateral relationship. These come in the form of agreements and cooperation in bilateral and international fora.

1) **Bilateral**

Existing

GI agreement - the EU-China agreement on geographical indications protects around 200 European and Chinese agri-food names against imitation and usurpation.

Bilateral dialogues and meetings - Various platforms and settings such as the EU-China summit and the High Level Economic and Trade dialogue as well as the EU-China inter-parliamentary meetings.

Awaiting ratification

CAI - the Comprehensive Agreement on Investment between the EU and China is surely the most prominent element in the current discussion. The agreement codifies existing and new market opening commitments and would create a forum to settle disputes. It contains sustainable development commitments, including labour rights, which however are only enforceable through a “soft” dispute settlement mechanism, without any recourse to sanctions. While falling far short of creating a truly level playing field, it would improve and solidify European market access and create a more amenable balance.

2) Pluri-/multilateral elements

WTO - both China and the EU remain, according to their respective governments, dedicated members of the World Trade Organisation. Nevertheless, it has become clear over the years that the rules governing the WTO are not in all cases capable of capturing the unique nature and challenges of the Chinese economic model. Rules governing transparency of subsidies, discussions on special and differential treatment and other topics such as the green goods initiative will be an opportunity to show not only that the WTO remains an important cornerstone of the global trade architecture, but also that its members are willing to engage in compromises to ensure the future of the institution.
While China's accession to the WTO has failed to deliver on all of the hopes for change, the influence of the regulator frame should not be underestimated either. It is important to continue to use all opportunities, especially now in the health and trade initiative, to expand the rules-based system for fair and sustainable globalisation.
Cooperation in other multilateral organisations such as ILO, COP and WHO on issues of labour rights, climate change and health will continue to address topics of common concern and will remain important for any bilateral discussions on said issues. Finding common ground on ways to address climate change would be a huge boost to global efforts and must be a priority.

Possible additional element

Steel forum - the highly sensitive European steel sector remains under steady pressure, partly due to global excess capacity and unfair trading practices by third country producers. One avenue to address the underlying causes of the situation is the global forum on steel excess capacity, in which China so far is not participating.

B) **Unilateral elements**

Clearly the EU and China do not see eye to eye on numerous aspects of their relationship. While in and of itself this may hold true for many of the EU's partner countries, the size, "creative" use of policy tools and assertiveness of China make it paramount to ensure, protect and strengthen the union's capabilities to act autonomously, pursue its own vision of a values-based global order and safeguard its industry from unfair competition. This requires the coordination of a wide range of instruments, many of which are still under development but urgently needed.

Existing

There are numerous, in general more traditional trade instruments the EU can draw upon to counter certain Chinese practices. The most widely used set of instruments are in the field of trade defence but other legislative acts such as the EU's investment screening regulation can play an important role in safeguarding EU interests. While the investment screening regulation is a key instrument in the EU's toolbox, it was adopted in a vastly different political climate than the strong emphasis on strategic industries and the fragility of supply chains we see today. Transparency and data are needed to be able to re-assess the impact and efficiency of the regulation. With the new anti-dumping methodology the EU has safeguarded the efficiency of the system, and with the appointment of the Chief Trade Enforcement Officer given a face to a more assertive EU on the global stage.

If the EU wants to fill its rhetoric of a "values based" actor with life, it must be able to show that it is capable and willing to protect and stand up for the universal freedoms and values it wants to promote. The use of the global sanctions regime in March 2021 was a long-overdue step to react to the allegations of human rights violations in Xinjiang. While the recent steps taking were of a more symbolic nature, the immediate Chinese (over)reaction showed the importance of publicly naming and shaming. The EU will have to continue to make use of this instrument in warranted circumstances and ideally in close cooperation with other allies.

Missing

There are several instruments in the making, which on the one hand safeguard European sovereignty and on the other strive to establish more reciprocal economic relations.

Based on the successful conclusion of the enforcement regulation, the European institutions agreed to immediately start work on an instrument to counter third countries trying to coerce the EU or its member states into withdrawing, adopting or adapting legislation or policies. This tool should have a strong deterrent effect and guarantee swift action by the EU. A proposal from the Commission is expected in the second half of 2021 which should then be swiftly dealt with by co-legislators and ideally adopted under the French presidency.

The International Procurement Instrument (IPI) would provide the EU with a lever to push for more reciprocal market opening commitments in the field of public procurement. Should third countries systematically block bidders from the EU, companies from those countries should face similar restrictions in Europe. After years of standstill, EU member states are finally moving in the direction of a common position, allowing the co-legislators to enter into negotiations on a final text in the second half of 2021.

The implementation of the white book on foreign subsidies should deliver additional tools to make subsidies third country companies benefit from more transparent and counter any distortive effects for the common market. The presentation of the Commission's proposal for this tool in May 2021 marks an important first step in bringing this piece of legislation to life.

A key instrument in shaping global value chains in a more transparent, sustainable and robust way will be legislation on due diligence obligations. This instrument should establish a common set of standards in the field of human and labour rights as well as environmental standards for companies placing products or services on the internal market. Companies will need to establish procedures to identify any risks in their value chains of violating these standards and devise ways to mitigate these risks. Accompanying this legislation should be a tool to prevent the placement of goods on the internal market that have been produced through exploiting forced labour. A proposal by the Commission is expected towards the end of the second quarter of 2021.

C) **Strategies and cooperation with other partners**

The EU's connectivity strategy has never received similar attention to its Chinese counterpart, the Belt and Road Initiative. A missed opportunity, but one that can be corrected. If the EU wants to be a credible actor in Asia, it needs to clearly communicate its goals and ambitions for the region and fill this vision with life. It must, much more forcefully than in the past, prove the advantages of its presence to the region.
One way to do this is through engagement in the form of trade agreements with countries in the Indo-Pacific, which in turn plays an important role in shaping EU-China relations. The EU has the potential to become and already partly is an alternative for countries feeling they are currently overly dependent on China or that are looking for ways to diversify. The EU has a wide network of FTAs in place with some countries in the region recently with a very good agreement with Vietnam and is currently negotiating intensively trade deals with Australia, New Zealand and Indonesia. Further agreements with Thailand, the Philippines and Malaysia may in the medium term compliment this network of FTAs. Recent signals promise substantial cooperation with India as well, the rekindling of the formerly stalled FTA talks send an important signal towards the region - especially after India withdrew from the RCEP negotiations shortly before their conclusion.
Taiwan takes on a key role in the value chains of many high-tech companies due to their dominant position in the production of semiconductors. Clearly it will be of importance for European manufacturers to ensure continued access to these products and thereby guarantee the seamless functioning of their production networks. Future avenues of cooperation should pay heed to this particular focus of the relationship.

What is missing from the picture so far is a vision of how these agreements should work towards the overarching goal of establishing the EU as a more powerful actor in Asia. The currently on-going work on a European Asia-Pacific strategy is the chance to provide such a strategic frame.

Cooperation with the other major player in Asia, the USA, should not be omitted from the discussion. There are clearly areas of common interest where cooperation with the Biden administration must be pursued. Topics ranging from state owned enterprises, cooperation in the WTO, digital standards and climate change are not only promising but would have a substantial impact on EU-China relations. Expanding the trilateral work with Japan and the USA on industrial subsidies to address general challenges of the role of states in the economy, distortion of competition and forced technology transfer is another avenue of cooperation with third countries that should be pursued.

Conclusion

The EU is at a crossroads. It is under immense pressure to position itself in the great game being fought out between the USA and China while delivering on its new priority of achieving "open strategic autonomy". The way it engages with China will have repercussions on its relationship with the rest of the world and the perception of the EU as a global actor - it is crucial that the EU finds its own voice in this situation and especially that it speaks with one voice only - a tall order.

The EU urgently needs to reach a consensus on its vision for what kind of relationship it wants to strive for. This means on the one hand identifying those areas in which cooperation is possible and needed. Even if the prospects of pursuing cooperative elements of the bilateral relationship seem slim, it would be a mistake to dismiss them. However much pressure there is on the EU, externally and internally, to adopt an aggressive stance on China, withdrawing from any forms of cooperation cannot be the key to managing this relationship. It will remain necessary to cooperate where possible and embed China in a global rules-based order - with updated rules that are able to tackle the very specific challenges posed by China.

It will be as important for the union to credibly underline that China's behaviour and influence must have clear limits - it is in the EU's long-term interest to have a clear vision of where these limits lie and what reactions a breach of these limits entails. The importance of a united EU cannot be overstated in this respect. It is questionable whether instruments that require unanimous decisions in Council can be effective in delivering that united front or whether formats like 17+1 are helpful in this regard in the short, medium or long term. Where the EU and China do not see eye-to-eye, the EU needs to be in a position to clearly articulate its interests and, if necessary, defend its policy choices - unilaterally or with like-minded partners. What is unquestionable in this regard is the need for the EU to deliver on the outstanding instruments outlined above. These will form the backbone of a China strategy that is robust and credible. But even these tools will not answer all of the complex questions that China poses. How should the EU react to "spontaneous" propaganda campaigns that lead to boycotts of European companies? Can there ever be a tool to deliver a convincing answer? We will need to constantly adapt our toolbox to newly emerging challenges such as these.

If there is anything to draw from the past months, then the realisation that the future of the relationship will surely not be determined by Europe alone - however much the EU may wish otherwise. The effects of "dual circulation" efforts by China may mean that economic opportunities and room for cooperation will already become more restricted in the short term. It is furthermore clear that while the EU is still figuring out what it expects the bilateral relationship to deliver, China is a step ahead in this regard and has a very clear idea of where it draws the line between cooperation and confrontation.