COMMENTARY
Thinking ahead for Europe

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EU-China Leadership in Trade Policy: Feasible? Desirable?

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Given the nationalism and blunt protectionism that characterises President Trump's trade policy, the primary focus of the EU should *not* be on how to respond to his rhetoric. The EU should rather double its efforts to pursue its own, sensible trade and investment liberalisation agenda. This is not only rational because of the economic gains that will come in the longer run from competitive winds that will blow in Europe, it is also appropriate because Trump is likely to find himself pretty much alone in his nationalistic and selectively protectionist agenda. The intended 'bilateral deal' approach, driven by (im)balances in bilateral goods trade, does not seem to have the backing of many, perhaps of no-one.

The challenge today for the EU and many of its trading partners is to build common strategies and convincing leadership in the world economy, with a view to supporting and bolstering multilateralism as the foundation of world trade, while continuing WTO-compatible (inter)regional, bilateral and plurilateral trade initiatives. The EU should be at the forefront of these initiatives.

This commentary will look at one principal element of such a trade strategy, namely, EU-China leadership. We shall touch upon three aspects in considering this critical option: the rationale for joint leadership; a reminder of what it takes for such a strategy to be credible; and, briefly, China's reform capability in light of the National People's Congress and the National Committee of the Chinese People's Political Consultative Conference (also known as 'Two Sessions') of March 2017.

Rationale

The EU and China are the biggest traders in the world economy. For well over one hundred countries, China is the first trading partner and, for many of these countries, the EU ranks second or third in terms of bilateral exchange. For several dozens of other WTO partners, the EU ranks first in their bilateral trade, with China having moved up to second, third or fourth position. Bilateral trade in goods and services between China and the EU is huge: in 2016 two-way goods trade amounted to €514 bn, and for services (2015) another €64 bn. For goods, this compares to trans-Atlantic trade, but for services, where the potential between China and the

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EU is much greater, services from China are only beginning to develop. Moreover, in both services and goods, the restrictiveness of China in terms of market access is far greater than that in the US and the EU. The same holds for the restrictiveness of China with respect to incoming FDI. The 2015 EU stock of foreign direct investment (FDI) in China was €168 bn, with Chinese FDI in the EU being €35 bn – a fraction of the trans-Atlantic values.

The US has withdrawn from multilateral and interregional (TPP!) trade initiatives, and some policy advisers are even casting doubt on the acceptability of WTO Appellate Body rulings that are adverse to the US. The leadership role to uphold multilateralism and further pursue trade initiatives must therefore fall to China and the EU. These two economies can do a good deal with their regional partners and the countries with which they are negotiating free trade areas (FTAs). A far more strategic move, however, would be to turn the EU-China trade and investment relationship into an example, thereby also creating a bundle of opportunities for many other partners.

China and the EU are continuously deepening their bilateral relationship as well, for example with over 60 dialogues and capacity-building exercises (e.g. in safety of consumer goods; in SPS matters; etc.) and ongoing talks on an investment agreement (CAI), partly linked to market access. China (via President Xi's call in Bruges in 2014) has suggested exploring a bilateral FTA. After some hesitation, the EU has begun to speak about this idea in positive terms, once the CAI is agreed. These intentions were exchanged in a world economy without Trumpism, however.

The EU-China FTA: a reality check

In Pelkmans, François et al. (2016), [1] a detailed factual analysis of a possible FTA between China and the EU has been presented, besides an economic impact assessment based on a modern CGE (Computable General Equilibrium model) and the Global Trade Analysis Project 2011 database. The underlying idea of the book is to better understand what it takes for both partners to conclude such an FTA successfully. After all, leadership is not a matter of 'convincing by speech' and 'vision' only, but of realising concrete results in terms of mutual market access and acknowledgement of opportunities by market players. The FTA assumed to be negotiated is a 'deep and comprehensive' one, as the EU now routinely negotiates with other partners such as South Korea, Vietnam, Singapore, Canada, Japan (unfinished) and (now pending) in TTIP.

Of these trade partners, only Vietnam is a developing country. China is more developed than, say, a low- middle-income country, like Vietnam, but nonetheless has many lingering development challenges. The 'deep and comprehensive' nature of the FTA is expressed in nine broad areas, all scrutinised in depth: industrial tariffs, agro-food tariffs and TRQs,[2] technical

[1] J. Pelkmans, W. Hu, F. Mustilli, M. di Salvo, J. Francois, E. Bekkers. M. Manchin & P. Tomberger (2016), *Tomorrow's Silk Road – assessing an EU-China Free Trade Agreement*, pp. 367, CEPS, also downloadable from www.ceps.eu; a lengthy Executive Summary in Chinese is downloadable as well.

[2] Tariff Rate Quotas, having zero or low tariffs for a first quota of imports, with very high tariffs beyond the quota of imports.

barriers to trade (TBTs), food and feed safety barriers,[3] market access in services, public procurement, IPRs (Intellectual Property Rights) and GIs (Geographical Indications),[4] SOEs (State-Owned Enterprises) and investment (the CAI). The overall conclusion of our work is clear: with the exception of TRQs, where the EU's TRQs are more problematic than those of China (both in number and complexity), China presents a wide-ranging set of formidable problems in its market access regimes.

The list is long:

- TBTs (Technical Barriers to Trade - partly systemic, as a legacy of planning and its institutions);
- SPS (sanitary and phytosanitary, or SPS measures - idem);
- services (with high degrees of restrictiveness, even more so when linked to SOEs and/or FDI);
- public procurement (where China's six offers to become a member of the plurilateral GPA[5] have not, so far, sufficed);
- IPRs and GIs (the regime of IPRs in China is up to international standards but its enforcement is weak; in GIs some first negotiation successes are accomplished but there are internal quarrels in China about brands and origin);
- SOEs (where next to no reform movement has been observed, throttling competition or even entry in a range of SOE-dominated markets); and
- investment (in 2014, China has the highest OECD FDI Regulatory Restrictiveness index, covering 22 broad sectors and 58 countries – including all BRICs and some other developing countries, as well as all OECD ones).

Chinese reforms and readiness for leadership

In the November 2013 Third Plenum, China presented an impressive vision of structural and wide-ranging reforms. These reforms were drafted largely in market-economy language and, for the most part, go in the right direction. However, they are not directly operational,[6] so it is critical to observe what operational reforms and implementation have been accomplished. Some clear examples can be mentioned (e.g. an overhaul of the technical regulation, standards and conformity assessment regimes and institutions, see Pelkmans et al., 2016, ch. 9) but overall there is widespread disappointment inside China and in European business. The wisdom of late 2013, which accords so well with sound long-run development and an open economy, seems to have been replaced by another wisdom that justifies slower progression.

[3] Called SPS (Sanitary & Phyto-Sanitary rules and procedures), subject to the WTO SPS Agreement.

[4] Geographical Indications (for food, wines and spirits).

[5] Government Procurement Agreement, going beyond basic GATT/WTO rules.

[6] For a more operational and detailed approach, see Chi Fulin et al (2016), Breakthroughs in transformation – the 13th five-year plan period, China Intercontinental Press, and CIRD (Hainan).

Li Keqiang, China's Prime Minister, recently chose not to reply directly to the question of what measures China would implement to convince the international community that the country is moving towards freer trade and an open economic development model. Instead, Premier Li said that China would have to sort out its domestic issues first, but conceded immediately that this undertaking would not be possible if "doors" were closed. He further stressed that reform is a gradual process and, looking at past decades, China's reform has made consistent progress. Yet the overall message conveyed at the Two Sessions was that China is scaling back its ambition of reform.

Further opening-up would benefit the Chinese economy. For example, if a bilateral FTA were to be negotiated (as in Pelkmans et al., op. cit.), the extra GDP for China (in percentages) would be 2½ times the gain for the EU. Note that the impact simulation is necessarily a considerable underestimation as the economic impact of the EU-China comprehensive agreement on investment (CAI), a prerequisite for a 'deep and comprehensive' FTA, is not incorporated. Greater openness beyond a bilateral EU-China FTA would bring further gains and should also underpin China's ambition of trade and investment within the context of the One Belt, One Road (OBOR) initiative, in which many European countries are involved via the AIIB.

Premier Li revealed at the press conference of March 15th that China had called for an acceleration of the CAI negotiations, and was awaiting a positive response from the EU. He then stressed that, even without the CAI, China would continuously enhance market access for, and extend equal ('national') treatment to EU businesses as if they were local Chinese enterprises. This would be very welcome news.

Nonetheless, the EU Chamber of Commerce in China looks less optimistic. According to the 2016 annual Position Paper published by the Chamber, many reform measures tabled at the 3rd Plenum (November 2013) have been left unattended, or at best only half done. In some areas, it is alleged that there were even worrying signs of "going back". After all, based on the OECD FDI Regulatory Restrictiveness index (2015), China moved only one position down to the second most restrictive ranking, after the Philippines.

Overall, market access may not be just a European problem. It could well be a Chinese problem, too, if one only realises China's activism in FTA negotiations. Presently, China is undertaking nine FTA negotiations, including the China-Japan-Korea trilateral FTA negotiations and the Regional Comprehensive Economic Partnership (RCEP) with the 17th round of negotiations concluded on March 3rd. China is conducting six FTA studies, in addition to a joint exploratory study of a Canada-China FTA building on the Canada-China Foreign Investment Promotion and Protection Agreement, which entered into force in October 2014.

Reflecting on China's FTA strategy, given that the FTAs with neighbouring countries seem to function (but are not 'deep') and that a basis has been formed in FTAs with developing countries,[7] it is time for China to approach 'great powers' and grasp the 'key' to further

[7] For details, please see http://fta.mofcom.gov.cn/english/index.shtml.

economic development.[8] Needless to say, before that can happen, China - herself a great power, must live up to the expectations of other 'great powers' in terms of economic openness. With uncertainty looming over the fate of the TTIP, EU Commissioner Malmström (in Singapore on 8th March 2017) unveiled the EU's global trade agenda of doubling down in advancing EU trade talks with partners around the world. Will China be ready to foster a closer trade relationship with the EU, as President Xi himself proposed three years ago?

Despite Premier's Li's call for an acceleration of the CAI negotiations with the EU, the EU remains reluctant to enter into FTA talks with China. In the new world of Trumpism, the sequence of first CAI and subsequent FTA talks might not be the best signal to send to China and the rest of the non-Trump world economy. Moreover, China shows signs of a shift towards another type of FTA: after all, the common vision shared by China, Japan and Korea for their trilateral FTA negotiations is 'comprehensive, deep and mutually beneficial', which corresponds to what the EU would want as well.

Both sides should now make a move: the EU should discuss with China at the highest level whether acceleration of CAI talks and granting more 'national treatment' by China to EU investors can lead it to reconsider the sequencing of CAI and FTA. And China, for its part, needs to accelerate the implementation of its reforms, especially those with relevance to market access and better market functioning.

Caution about domestic reforms may reflect Laozi's wisdom that governing a great nation is like cooking a small fish – too much handling will spoil it. But China should not forget that its audacious reform undertakings in the past accelerated its successful economic transformation to an extent that no other country in the world has achieved. The EU and China are moving in the same fundamental direction, as became clear from President Xi's positive words about globalisation and his pledge at the World Economic Reform[9] to promote trade and investment, liberalisation and facilitation through opening up, which was a firm 'No' to protectionism.

[8] Announced by the Ministry of Commerce in December 2015, China's FTA strategy has four major dimensions: great powers as the key, neighbouring countries as the priority, developing countries as the basis, and multilateralism as the important venue.

[9] Davos, 17 January 2017.