Die EU, China und die Drohungen des Protektionismus

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European official attitudes towards China's trade policy have lately become shrill and confrontational. Frustrated by EU's soaring bilateral trade deficit with China, Peter Mandelson, the EU trade commissioner, last autumn warned China of this "policy time bomb" and what would happen unless China did something to stop the ballooning deficit. The time for soft talk with the "juggernaut" was over. European leaders, such as Nicolas Sarkozy, have accused China of currency manipulation and threatened China with forceful trade-defense actions. European governments have introduced investment legislation targeting countries like China. An increasing number of China's export goods also face difficulties with product-safety standards and other regulations, which surprisingly often err on the side of protectionism.

Europe is not the only party to blame for deteriorating political relations over trade. Beijing, for its part, has contained its anger over Europe's new China-bashing, but it has not done much to prevent it. Invitations from Brussels to avoid a tit-for-tat protectionism have met only feeble responses. New certification requirements discriminating against foreign producers have recently been introduced. Some tariffs have increased and China was recently ruled against by the WTO for its sudden increase of tariffs on automobile parts. China's increasing ambitions to use its giant capital reserves for industrial policies, primarily subsidizing inefficient firms through the state-owned banks, have diluted Beijing's previous ambitions of strong and sustained market liberalizations. China's programme of root-and-branch trade and investment liberalization has clearly slowed down, and in some instances event reverted, in the post-WTO accession period.

It is clear that the EU and China need to get away from the current slide in its trade politics. It is always easy to sound criticism and issue harsh statements over the practice of its trade partners. But the plain fact is that commercial relations between Europe and China are too important to let them become hostage to political grandstanding or airy rhetoric by politicians performing for its domestic gallery. This article examines the arguments behind Europe's new confrontational approach to China. Especially it discusses the ballooning deficit Europe has in its trade with China and whether this warrants protectionist actions from the European Union.

Mapping EU-China trade

The European Union and China are two giants in the world economy. They rank, respectively, first and third when global trade is measured. Europe is China's largest export market, and China now ranks second on Europe's list of key trading partners. Only the United States has a greater volume of trade with Europe. Trade with China dwarfs any other trade relation Europe has with emerging Asia. European firms have invested over 70 billion USD in China, and they generated total sales of more than 130 billion USD in 2006. As China accounts for 10 percent of world trade and in 2007 represented almost 20 percent of world growth, it is today at the centre of globalization and the world economy.

This is phenomenally good news. Thirty years ago, China was a closed, centrally-planned economy which grew poorer rather than richer. In the last two decades, China has moved out of its economic autarky and entered the world economy. The Chinese market growth offers plenty of opportunities to foreign companies, and Chinese export gives other parts of the world access to cheaper goods. Yet many politicians find the trade relation to China unbalanced. In fact, China's economic rise is considered to be one of the greatest challenges to the economic performance and welfare in Europe and the United States.

Politicians in the United States have in the last ten years complained about America's trade deficit to China and called for protectionist actions. Some members of the Congress has called for a tariff of 27,5 percent on all Chinese export to the US. Luckily, that bill has been shelved, but the Congress has meddled with other trade-policy instruments and blocked an acquisition of a US company by a Chinese firm. Barack Obama and Hillary Clinton have both lent their support to overtly protectionist actions against China, yet regardless who wins the US presidential election he or she will have to deal with an increasingly protectionist US Congress.[1]

European policymakers are now sounding similar criticism. At the centre of Europe's new bashing of China is its growing bilateral trade deficit. Undoubtedly, this deficit has grown rapidly in the last decade and hit approximately 190 billion euro in 2007. This growth is unprecedented. Europe's trade deficit to Japan grew sharply in the 1980s, when Japan was seen as a great threat to wages and welfare in the Western world. But neither Europe's nor America's deficit with Japan never increased (not even when measured in real terms) as much as their deficits in dealings with China today.

The numbers are impressive, but the nature of this deficit, and its effect on Europe's economy, has been much exaggerated. In fact, the notion that the bilateral trade relation between EU and China is worrying does not stand up to greater scrutiny. The argument that Europe would benefit from taking trade-corrective actions against China is economically nonsense. What are the reasons for this dismissal of the the EU official criticism of its trade relation with China?

Debunking the arguments for protection or corrective measures

Firstly, the notion that a *bilateral* deficit represents a problem which must be corrected is simply bad economics. A trading entity like the EU has surpluses in its trade with some, and deficits in its trade with others. This is nothing but natural. Trade is about exploiting the benefits of specialization and comparative advantage. Since countries have different economic structures and offers different benefits, the outcome of a country's bilateral trade relation varies considerably.

In contrast to the United States, Europe's overall current account is in balance and has remained stable in the one-percent plus or one-percent minus region (of GDP) for the last ten years. Germany has been one of the most successful countries in Europe to exploit opportunities from globalization. Germany's trade has increased considerably in the last years and the trade surplus is substantial. If a bilateral deficit really constituted a problem, Bulgaria, Estonia, France, Romania, the UK, and several other trade-deficit countries in the EU should rather be worried of their deficit in trade with other European countries, which dwarfs their deficit in trade with China. Estonia, to take one of the extreme examples, had in 2006 a deficit in its bilateral trade with the EU representing 45 percent of its GDP; Estonia's bilateral deficit with China represented merely 1,9 percent of its GDP.

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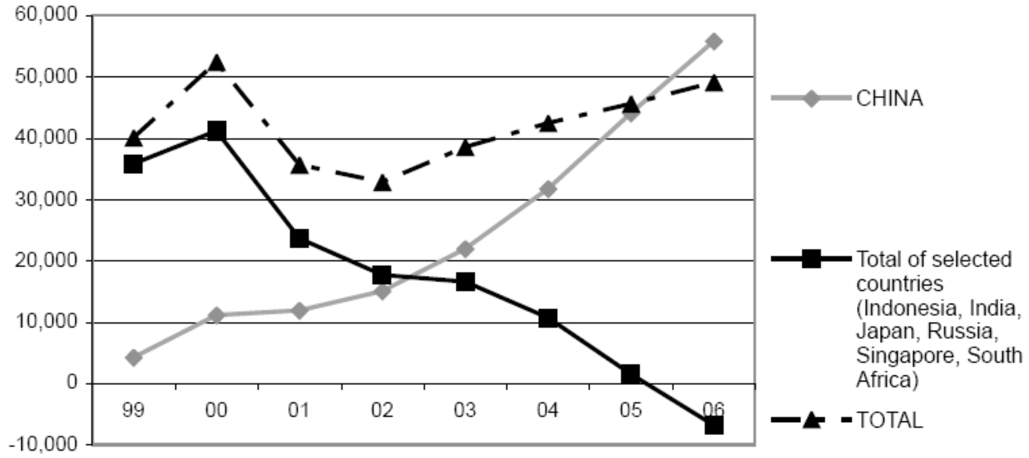
[1] See Dan Steinbock (2008) US Presidential Election 2008: Policy Implications for US-China Trade and Investment. *China & World Economy*, vol 16:3

Secondly, the EU's ballooned trade deficit with China largely mirrors trade replacement; that is, China's increasing export to Europe has been accompanied by falling exports to Europe from other emerging countries. Let us take the example of EU's trade in machinery and transport equipments. Largely based on labour-intensive production, this category of goods is one in which China has recorded strong trade growth. In 2006, approximately 50 percent of China's total export was in this category. China's trade surplus with Europe in this category increased with 50 billion euro between 1999 and 2006. But as shown in graph 2, EU's import from other emerging economies of goods in the same category has decreased with nearly as much in the same years. In net terms, Europe's trade deficit in this category did not change at all between 2000 and 2006. Similar patterns exist in other categories of trade: China replaces other trading partners.

Graph 2: EU trade with China and a selected group of countries in 1999-2006 in the category "Machinery and transport equipment"



Source: Eurostat; own calculations

In the last two decades, China has established itself as a hub for Asia's trade with Europe. Supply chains in multinational firms have been fragmented to take advantage of lower labour costs and specialization in various countries. A large part of China's export is therefore accounted for by increasing import – and this import is necessary for China to export. Processing trade, which is economic jargon for the refinement or assembly of imported goods before they are re-exported, is estimated to represent between one half and two-thirds of China's total exports. In recent years, the domestic content of China's export has increased, but China's trade performance remains to a great extent a story of processing trade.

Thus, China's increase of export to Europe does not equal a fall in Europe's production. Similarly, if the EU was to take protectionist action against China, production would not repatriate to Europe, but rather to other emerging countries, even if measures would be unexpectedly harsh.

Furthermore, Europe would not stand to benefit from such actions. Some politicians have toyed with the idea of introducing a tariff against China's export to Europe; others rather favour an appreciation of China's currency, which also would raise the cost of China's export. Regardless the choice of weapon, the short-to-medium term effect for Europe would be higher prices and lower purchasing power. European consumers would pay more for fewer goods. The long-term effect would be a replacement of export to Europe from China to other emerging markets. Production would not move back to Europe. Its trade deficit would not be affected.

In fact, production should not return to Europe. The typical export good of China to Europe is from a sector in which Europe has not had comparative advantages for a long time, which means that Europe could only resume its own production at the expense of its own welfare (as it would need stop producing some of its current production).

Corrective actions against China would also have adverse effects on European producers. Globally-oriented firms in Europe have been given better opportunities to increase their competitiveness by trading with China. By sourcing production to China it has lowered the price of input goods. Many European multinational firms have today dense, sophisticated production networks which facilitates a lot of input trade before the final good is assembled and shipped off to the importer. Mending these networks, which trade-corrective measures certainly would do, have potentially disastrous consequences for European firms. They would certainly raise the production cost for European companies.

A non-normative approach to the surplus

Thirdly, the analytical framework behind the calls for correction – either by trade measures or monetary policy – is flawed also from the vantage point of macro-economic analysis. A number of scholars and analysts have claimed that China's currency is misaligned or, worse, manipulated in order to boost export. The prime evidence in favour of this proposition is China's huge current account surplus and its build-up of foreign reserves.

However, determining the correct value of a currency is inherently difficult, and neither the studies suggesting an undervalued Chinese currency nor the studies suggesting a balanced or overvalued currency come up with robust results. There is also a fundamental problem with most of these analyses: they fail to take account of capital flows when China's current account is analyzed.

Capital flows are central in today's international economy, and a country's economic relation with the world cannot be understood without analyzing the capital account. Therefore, a balance of payment approach, accommodating capital flows as well as trade flows, is arguably necessary in order to understand China's international economic relations. [2]

When taking this approach to the issue of Europe's bilateral trade deficit with China, it is clear that there is no normative implication as such for any particular current-account balance. It cannot be said in advance if a current-account deficit is undesirable or not. The exchange rate, which is considered by some as the vehicle for a surplus or a deficit, is not a policy variable in this perspective. It is an adjustment parameter and it is determined by other factors, especially the decisions of households and governments between consumption and saving.

For example, it can be sensible for developing or emerging countries, or a country with a relatively young population (such as the US), to run a current account deficit as a response to net capital

[2] For a balance-of-payment approach towards China, see Andreas Freytag (2008) *That Chinese "juggernaut" – should Europe really worry about its trade deficit with China?* ECIPE Policy Brief 02/2008.

inflows if these are invested. Ageing economies such as Germany or Japan for their part may be better off with a current surplus, investing their savings abroad. Developing countries (such as China) may run a current-account surplus to invest into future net capital inflows or to import know-how for long-run growth. Furthermore, for a country with an appetite for savings and investments, but with an unsophisticated domestic capital market, it appears rational to park savings abroad. In any case, an imbalance in the current account is not necessarily a disequilibrium and a sustained current account surplus cannot be definition be considered as a policy strategy based on a depreciated exchange rate.

The way forward

European politicians appear to follow US policymakers in opting for a shrill and confrontational attitude towards China's trade surplus and its allegedly misaligned or manipulated currency. This is a misguided strategy. It is based on an erroneous analysis of what determines Sino-European trade and it will lead less welfare for European consumers.

Europe should rather design policies which will facilitate a deepening of its relations with China. It should lower its own barriers to China's export – tariffs as well as non-tariff and other barriers – but also ask China to open its market to a greater extent.[3] China's services markets, for example, remain heavily protected and should be liberalized. Its record of protecting intellectual property is unsatisfactorily. Chinese reform on both accounts is desired, but it cannot be achieved in an increasingly hostile trade atmosphere.

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[3] For a discussion of deepened trade relations between EU and China, see Iana Dreyer and Fredrik Erixon (2008) *An EU-China trade dialogue: a new policy framework to contain deteriorating trade relations*. ECIPE Policy Brief 03/2008; Patrick Messerlin and Jinghui Wang (2008) *Redesigning the European Union's trade policy strategy towards China*. Joint ECIPE-GEM Working Paper 04/2008