

Future Opportunities and Challenges in EU-China Trade and Investment Relations 2006-2010

EXECUTIVE SUMMARY

China's rise epitomises the challenge of globalisation for EU business

Formulating a response to China's rise is akin to formulating a response to globalisation itself. Chinese industry has become a global leader in labour-intensive manufacturing based on a comparative advantage in cheap labour which will likely be maintained for the foreseeable future. European operators, who rely on a highly educated workforce, are at a disadvantage in commoditised markets where price plays the most important role.

Within China, increasingly fierce competition and a search for new markets by Chinese domestic companies is resulting in price cutting, aggressive export-driven expansion into third markets, and rapid industry consolidation. Although the picture varies per industry sector, local state support and intervention continues to play an important role in determining the outcome of this process. This has enabled Chinese competitors to increase the quality of their goods and services while leveraging their low-cost base to exploit opportunities, not just in their domestic market, but increasingly also abroad.

These trends are particularly apparent in sectors which have traditionally been important to the European economy, such as industrial machinery, automotives, ICT equipment and certain chemicals. In these sectors Chinese producers are already seen increasing their activities in markets where European companies until recently enjoyed a dominant position, particularly in emerging markets such as ASEAN, South America, the Middle East and Africa.

In responding, EU business can draw on key competitive strengths

I. Considerable Strengths and Opportunities for EU Business

Despite these trends, European operators continue to build on their sizeable advantage in higher value-added economic activities. Their competitive strength in this area is comprehensive and, unlike many of their Chinese competitors, built on solid market fundamentals. European operators are consolidating their strengths in services by offering new 'integrated solutions' which go far beyond the traditional selling of commoditised goods. By talking to industry practitioners, this study has identified the following areas on which European companies increasingly compete:

- Innovation and R&D
- Design
- Marketing and branding
- Servicing (after-sales, customised solutions)
- Management operating systems
- Overall superior quality of goods and services
- Financial strength (applies mainly to multinationals)

... to seize the enormous opportunities created by new trends in the Chinese market

This study highlights the emerging opportunities that result from these strengths in each of the sectors explored in this study¹. In order to take full advantage of opportunities in China, it is essential that European operators acquire a better knowledge of this increasingly complex market and to build strategies and design products around local conditions. The European Commission can play a key role in overcoming these complexities, in particular with regard to market access obstacles. In the near future, the

¹ This study explores sub-sectors within the Machinery, Chemicals, Automotives, Pharmaceuticals, ICT Equipment and Agriculture, as well as Financial Services (Banking and Insurance), Distribution (Retail), Construction and Telecommunication, sectors in which particular opportunities for European companies exist.

most important of these opportunities will be found in:

A rapidly growing market – with new opportunities in services: China remains for the foreseeable future the world's most important emerging market. European industry within the tradable goods sectors explored in this study should focus on gaining market share in the higher-end markets that are expected to grow on average 12% per annum, reaching a combined value of over €1,000 billion by 2010. Growth in the service sectors², where Europe has the most significant comparative advantage, is outpacing that in other sectors (14% per annum, reaching a market value by 2010 of €500 billion - excluding banking services). This will offer the biggest future opportunities for European companies. Unfortunately, it is also within many service sectors that currently some of the largest obstacles to trade and investment are found.

Changes in consumption patterns: China's middle class is expected to reach over 150 million by 2010. This is bringing about new market opportunities for consumer-oriented businesses which focus on high quality segments. Rapid urbanisation and an ageing demographic structure will further influence the business strategies of European operators. The business-to-business market will also expand rapidly.

Cost cutting opportunities: European operators are at a biggest competitive disadvantage in commoditised markets where competition on price plays the most important role. In these markets only those who successfully integrate China into their production chain or source supplies from other low-wage countries are able to compete. With European operators out-performing local competitors in services, European manufactured goods which contain a service element or other high value-added in the form of R&D and design are largely able to retain their global market share by differentiating their products from local goods. The machinery and automotive sectors provide good examples of this, where companies are developing a dual strategy of developing cost-cutting through China-based manufacturing while at the same time capturing the emerging Chinese market for quality products.

Environmental requirements: through its 11th Five-Year Programme, China has set the target of achieving more sustainable growth through increasing energy efficiency, investing in renewable energy and improving overall environmental protection. This has considerable implications for Europe's materials, engineering, construction, machinery, chemicals, automotive and ICT sectors. It is estimated that the market value for the application of environmentally sustainable technologies and services in these sectors could amount to over €98 billion by 2010.

But European companies face substantial market access barriers

II. Market Access Barriers to Trade and Investment in China

Since WTO accession in December 2001, China has made progress in liberalising sectors by formally adapting its laws and lowering tariffs in line with its accession commitments. However, implementation at the provincial level has not always followed the spirit of China's WTO commitments. State-led industrial policies and the use of non-tariff barriers (NTB's) have shaped the evolution of nearly all of the Chinese sectors reviewed, particularly those deemed 'strategic' sectors. Many of these policies result in unequal treatment of European operators in sectors ranging from machinery and automotive to services like construction, finance, and telecoms.

The drive to boost innovation in China has resulted in aggressive acquisition of foreign Intellectual Property, supported through technology transfer obligations and a generally ***lax enforcement of Intellectual Property***

² Financial Services (Banking and Insurance), Distribution (Retail), Construction and Telecommunication

These barriers cost EU firms more than € 21.4 billion a year in missed business opportunities.

Opening the market would benefit both the EU and China.

Rights. The cost for European companies is substantial. A representative from the Machinery sector indicated that if current trends in IP infringement continue, companies in his sector would typically expect to see a loss of revenue of over 20% - a cost higher than any other single NTB.

Substantial **subsidies**, disbursed through various forms, create soft budget constraints for State-Owned Enterprises (SOEs). The close links between Chinese regulators and SOEs and their respective provincial governments and local enterprises leads to issues of **transparency** and **unfair treatment**. **Lack of uniformity** of regulations in different Chinese provinces is also problematic as foreign operators expand their local presence.

Government procurement often remains opaque and discriminatory. In 2004, direct government procurement accounted for about 1.3% of China's GDP. However, with public spending on non-salaries standing at approximately 15% of GDP, the scope of expansion is large and highlights the limited development of Chinese public procurement which also reduces opportunities for European companies. **Equity restrictions** on foreign investment still remain in a multitude of sectors. Access to the Chinese market is often complicated by an ambiguous **standards and compliance regime** resulting in technical barriers to trade (TBTs). **Lax enforcement** of environmental and labour standards alleviates the potential cost burden resulting from compliance for Chinese competitors.

Costs of Non –Tariffs Barriers to European Operators: Over € 21.4 billion.

Based on the data collected for all the manufacturing sectors covered in this study, European exporters of traded goods face an estimated total of € 12.5 billion (US\$ 14.6 billion) of costs in 2004 in lost export opportunities as a direct result of non-tariff barriers in China. In addition, for three service sectors alone, financial services, telecoms, and construction, the latter two which are in effect closed to European operators, the figure is estimated to have exceeded € 8.9 billion (US\$ 11 billion) in the previous year.

Trade barriers also hurt China: scenarios for the future show win-win solutions.

For each sector, this study presents pessimistic and optimistic scenarios for the future, depending on the prospects for further liberalisation policies by the Chinese authorities. It is striking to see that optimistic scenarios result not only in better market performance for European business but also in overall welfare benefits for Chinese consumers and improved, longer-term, prospects for the competitiveness of Chinese businesses. In particular, China would benefit greatly if it were to adopt international standards which, instead of developing China-only standards that slow market access for foreign companies, would enable Chinese companies to compete more effectively on foreign markets where such international standards are used.

III. Trade Policy Recommendations

With the end of the 'honeymoon period' following China's accession to WTO, some conservative voices within China are increasingly advocate market protectionism and have recently achieved some victories, for instance with the recent appearance of regulations tightening restrictions on foreign investment. However, as the study shows, there remains an underlying need for continuing reform and market opening. In view of this, European trade policy should **press China to fully implement the spirit of its WTO commitments and support further liberalisation of its economy**. More specifically the study recommends:

- **Establishing a better EU-China dialogue on strategic economic issues at senior government level:** While trade and investment barriers are high on the agenda of EU-China relations, they should not inhibit engagement on broader, long-term issues of socio-economic reform

Improved dialogue with China that focus on further market opening...

... and supports EU companies in accessing the complex Chinese market

...will allow both sides to draw the full benefits from complementarities between the two economies.

and sustainable development. Progress in these areas is the key to the removal of costly non-tariff barriers and other barriers and will only come through deeper reform-orientated, synergistic strategies.

- **Expanding the Commission's local presence across China.** This will help in dealing with the multitude of regional issues in China. Strengthening the on-the-ground presence of European standards organisations and industry associations and deepening cooperation with Chinese counterparts.
- **Enhancing awareness of risks associated with investing in China:** Establish a risk monitoring body to alert European investors, especially SMEs, to potential hazards of operating in China and to advise on ways to mitigate these risks when structuring investment decisions. Dissemination could be supported by EU Member States trade offices and European trade associations. This would give incentives to provincial governments in China to improve local business environments.
- **Stepping up efforts to meet the goals of the Lisbon Agenda:** Key to competitiveness in Europe is a domestic regulatory environment which fosters entrepreneurialism and innovation. Reallocating resources away from uncompetitive, labour-intensive industry into the high-value added knowledge economy will enhance the complementarities of the European and Chinese economy and reduce trade friction.

Trade Policy Recommendations by Trade Issue

- Monitor China's implementation of its **Intellectual Property Rights** Action Plan and other IP commitments in the form of comprehensively designed industry questionnaires and thematic studies.
- Support China's accession to the WTO **Government Procurement Agreement** (GPA). Highlight the economic and political benefits of procurement reform and provide technical assistance where necessary.
- Support Chinese customs reform to ensure uniform implementation of the WTO **Customs Valuation** Agreement, and actively engage with China on Trade Facilitation in order to reduce Customs formalities.
- Encourage China to adopt existing **international standards** and build mutual recognition of its national standards where possible.
- Highlight the benefits of an **Foreign Direct Investment regime** which is more flexible than the existing range e.g., JV and local content requirements, obligatory technology transfer etc. This should be done in consultation with both foreign investors and Chinese counterparts.
- Engage in dialogue on the use of **subsidies** which distort trade and make use of anti-subsidy provision under the WTO where necessary.
- Emphasise the importance of **independent regulation** of industry through separation of regulatory and business functions, and administrative reform.
- Ensure that **technical assistance** is provided in areas deemed of strategic priority for both sides and that technical assistance is closely coordinated with policy action.