

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

---

## MAIN FINDINGS OF THE STUDY

China's rise presents a great challenge to the global economic system. European operators are beginning to compete head on with Chinese industry and formulating a response to China is in many senses similar to formulating a response to globalisation itself. A low-wage workforce, driven by a surplus of labour, which forms the main thrust of China's competitive advantage, is common to many developing countries, though not all have been able to climb the technology ladder and boost productivity as quickly as China has. Europe, along with other developed economies, where ideas and the production of knowledge drive economic growth, must therefore carefully consider its role in the global economy and focus on what it does best. This study seeks to identify ways in which following a path of open competition with the world's most populous nation can produce gains for all.

## I. EU BUSINESS CAN DRAW ON IMPORTANT COMPETITIVE STRENGTHS

In terms of competitiveness in labour-intensive manufacturing, Chinese industry is second to none. However, European operators still enjoy a sizeable advantage in higher value-added economic activities such as:

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

The range of competitive strengths of European operators is therefore relatively comprehensive and covers nearly all aspects of the spectrum of competitive factors except for price with the exception of some large retailers who are able to leverage buyer power. Therefore, at this stage, it is useful to make a number of distinctions.

The first distinction is to be made between manufacturing and services, while the second distinction is between commoditised markets and specialised high value-added markets. Clearly, European operators are at a competitive disadvantage in commoditised markets, in which price plays the most important role. It is in these markets where European operators are faced with the greatest pressures and only those which successfully relocate production to or source supplies from low-wage countries are able to compete.

Those European manufactured goods which contain high value-added in the form of R&D or design are largely able to retain their market share in European markets by differentiating their products from Chinese goods. This applies equally to export markets. As incomes in China grow, demand for higher value-added products will also increase, presenting significant opportunities for European operators. Moreover, as environmental standards are raised in China, European operators will be able to offer the world's leading environmental products as well as the technologies for cleaner production, renewable energy etc.

However, with Chinese manufacturers climbing the value chain, new challenges to European companies are emerging. A general increase in the quality of goods and services (e.g. machinery, automotive, ICT, chemicals) combined with low-cost bases allows for entry into markets which were once the domain of European companies, particularly rapidly emerging markets such as ASEAN and globally in South America, the Middle East and Africa.

In the services sector, the advantages enjoyed by European operators are considerable. Looking forward over the next 5 years, the period this study focuses on, there is little to no evidence of an

emerging, globally competitive, Chinese service industry. Only sporadic evidence exists that in some sectors, notably construction Services, Chinese competitors have been able to leverage their lower-cost technical workforce in third markets. However, it is questionable that this low-cost model is relevant for the provision of services in the long term. In addition, the weakness of China's domestic institutional framework, particularly apparent in the financial services industry, will stymie the development of China's services industry as long as reforms are not introduced. Although a strong case can be made for arguing that the increased participation of European companies in service sectors would be greatly beneficial to the Chinese economy – through the transfer of best practice and serving an increasingly unmet demand for sophisticated services – it is also the case that investment barriers for service sectors in China are among the highest.

***In all sectors, reacting swiftly to new paradigms and globalisation trends will be key to maintain Europe's competitiveness. It will be equally important to improve the domestic factors of competitiveness (Lisbon Agenda).***

**🔗 Cost competitiveness:** Just as the lower costs of goods from China benefit European consumers, these trends bring challenges to European operators to reduce their own costs in order to maintain competitiveness.

**🔗 New concepts for home markets:** Growth trends in the Chinese market can also lead to new innovations that can inspire European operators to develop new concepts and business practices which can then be adapted and applied in Europe.

## II. CHINA OFFERS IMPORTANT OPPORTUNITIES FOR EUROPE IN EACH SECTOR

In the ***machinery sector***, the drive for lower energy intensity will lead to an increased demand for more energy efficient machines, power generators and renewable energy-related equipment, a field in which the European machinery industry excels. European operators must continue to capitalise on their superior knowledge of producing specialised, innovative, highly integrated and precise machines. Projections to 2010 put sales growth for European companies at 10% per annum, making China the market with the highest growth potential in the Asia-Pacific region for customised services. While China still has a trade deficit in machinery, import substitution strategies should result in a trade balance by 2008-2010.

In the ***chemicals sector***, 2004 saw China's chemical imports (including pharmaceuticals) valued at around €44 billion (bn) and the size of the domestic market reach around US\$ 180 bn. If further reforms (e.g. improved IP protection and the company law regime) continue to support market growth trends in key customer industries (manufacturing, construction and farming) the chemicals industry will grow at a compound annual growth rate of 10.2%. European commodity chemicals producers in upstream segments should leverage their financial strengths and invest in China, while speciality and fine chemicals producers should seek further export opportunities in China. Chemical companies should continue to capitalise on the strength of their customer relationship management expertise to provide customer specific R&D and servicing. Overall, European operators should build on their position as the world leaders in terms of energy efficiency, environmental management and the development of environmentally-friendly materials.

The ***automotive sector*** in China will see moderate to strong growth leading to overcapacity and increased local competition. Auto production capacity in 2010 is expected to be more than double domestic demand, increasing from approximately 8 million units a year to 16 million vehicles by 2011. The rapid introduction of new models in the Chinese domestic market will ensure that car parts will be an important export sub-sector for European companies. Furthermore, increased competition in the passenger vehicle sector in China could accelerate developments in low-cost, city-use vehicles which can also be marketed in Europe. Eventual crackdown on rapidly-deteriorating air quality in China will result in higher emissions and fuel quality standards, which will provide distinct advantages for European automakers since the standards are modelled on those in Europe.

In the ***pharmaceuticals sector***, continued economic growth and rising living standards will result in the emergence of "diseases of affluence" in Chinese society. Longevity and the ageing population will fuel demand for drug categories that have preventative qualities e.g. OTC pharmaceuticals and

nutraceuticals, resulting in expected sectoral growth at approximately 10% per annum over the next five years. Other important trends include the growing use of self-medication facilities. Companies should explore innovative distribution channels in China, building on trends such as the emergence of pharmacies within retail chains in Europe, particularly as European retailers are rapidly developing their networks. An overall positive outlook relies on continued macro reform and an improvement in IP which will weaken the dominance of Chinese generics over foreign drugs. A strong rural strategy is required so that disparities in healthcare expenditure between more affluent coastal regions and rural areas are reduced. European operators may introduce Traditional Chinese Medicines within their product ranges in Europe allowing new growth opportunities. Considerable opportunities exist for European companies to leverage cost advantages from R&D in China.

#### ***Macro Trends Create Opportunities for European Operators***

**🔑 Environmental requirements** for product features will be increasingly important in China. Through its 11<sup>th</sup> Five-Year Programme (11<sup>th</sup> FYP), China has set itself the target of achieving more balanced and sustainable growth where increasing energy efficiency, investing in renewable energy and overall environmental protection plays an increasingly important role. This has considerable implications for Europe's materials, engineering, construction, machinery, chemicals, automotive and ICT sectors. Service sectors can also take advantage of their product offerings to support environmental applications.

**🔑 Changes in consumption patterns:** As China's middle class continues to grow in number there are increasing market opportunities for all consumer-orientated businesses and secondary positive effects for business-to-business operators. Rapid urbanisation and an ageing demographic structure will further influence the business strategies of European operators in the Chinese market.

In the ***ICT equipment sector***, European operators should compete on IT design rather than in the manufacture of commodities. Future export opportunities should be targeted at those industries where the EU has established competitive advantage e.g. precision machinery, energy efficiency and pollution reduction technologies for the chemicals, automotive and agriculture sectors. This will help to ensure that European companies maintain their current levels of market share for which projections of US\$ 130.5 bn in terms of revenue have been made for 2010. An overall positive outlook will require China to move towards adopting international standards to further market access.

Currently, ***agricultural exports*** rank 6<sup>th</sup> in importance in terms of EU goods exported to China. However, EU exports to China have been unable to reach full potential due to market obstacles such as China's SPS regime, insufficient logistics for transport to and from China as well as storage in China, and insufficient protection of intellectual property rights for some high-value agricultural products. Export opportunities exist in the agricultural services sector as the EU has substantial experience in organic production, value-added food production and sustainable land management. European operators also have considerable investment opportunities in China's rural economy such as in irrigation systems, supply chain management services, eco-tourism and biodiversity protection.

In the ***financial services*** sector there exists significant opportunities despite ongoing market access restrictions. Strong growth in the Chinese economy requires further reform and opening of the banking sector to meet the predictions of sustained 20% annual growth of consumer loan business, 50% in credit card business and 15% in business transactions. Due to limited market access, current market share of European banks is only 0.8%, though this is expected to grow to 3.5% by 2010. In insurance, the transition from state pensions and social support to private insurance provides foreign institutions with a chance to increase market share from 2% to 10% in the coming decade. European insurance houses' non-life and life insurance market shares are expected to grow from 0.4% to 5% and 0.8% to 8% respectively by 2010. European banks and other financial institutions should support Chinese banking reform, and bring innovation such as public-private partnership investments and excellence in customer servicing.

The opportunities presented by China are perhaps the biggest for European ***retailers***. Foreign retailers are sourcing an increasing amount of products from China for their home markets (US\$ 60 bn in 2005) and foreign expansion into the Chinese retail market continues, where total sales are predicted to grow at an average rate of 10.1% until 2010. Competitiveness in retail, gained by focusing on lean operations, supply chain management, integrated procurement, effective quality controls and management flexibility, and the ability to identify with local consumer preferences

places European operators in a strong position. Chinese consumers are increasingly willing to pay higher prices in return for confidence in product quality and food safety. Sales of consumer goods (retail and wholesale) driven by strong growth in disposable incomes, urbanisation and population growth were estimated at €618 billion by the end of 2006 with 4% of sales by foreign retailers. This could grow to between 8% and 10% by 2010, though the dominance of European retailers will somewhat diminish as US retailers catch up.

The **construction** sector's share of national GDP rose from 6.7% in 1998 to 7.0% in 2003. This increase together with an average annual growth rate of 8.3% between 2000 and 2005, and an estimated annual growth rate of 7.5% during the implementation period of the 11th Five-Year Programme (2006-2010), indicates the significance of this sector in China. This indicates that China will be the world's largest building and construction market for the foreseeable future. While Chinese companies are in general low-cost and relatively efficient many lack the key expertise and management skills to handle large and sophisticated projects. The European construction industry is well positioned to take advantage of these capability short-falls and has global experience in adopting cutting-edge technologies in large infrastructure projects, as well as new concepts in sustainable building systems. However, beyond limited high-profile show-case projects, European construction companies are being excluded from the larger markets, in particular the housing market. They have difficulty therefore in demonstrating their ability to offer integrated services throughout the entire life-cycle of a project.

China's **telecommunications value-added services** market remains all but closed. There is little prospect of foreign companies increasing their current minimal market share by 2010 unless China revises the current legislation governing the Telecommunications sector, and lifts the equity ceilings on foreign investments (for example by allowing them to provide backhaul and to market services to corporate customers). As a means to circumvent restrictions in the telecoms and other hi-tech sectors, European operators should seek partnerships with those influential Chinese operators seeking strategic alliances in China (and internationally) for the integration of services in advanced service applications, high quality of customer relations, and management and marketing skills.

### **III. NON-TARIFF BARRIERS COST EUROPEAN COMPANIES OVER € 21.4 BILLION IN LOST BUSINESS OPPORTUNITIES**

Since WTO accession in December 2001, China has made recognisable progress in liberalising sectors, introducing and amending laws and regulations and lowering tariffs in line with its accession commitments. However, **a complex mix of "behind the border" barriers** faced by European exporters and investors in China still remains. The range of policy instruments vary from selective public procurement, state sanctioned dissemination of unlicensed foreign IP, restrictive investment rules, local content requirements, complex technical standards, subsidies and other forms of financial incentives for Chinese companies.

#### **A. Assessment of the cost of Non-Tariff Barriers**

**Table 1** lists the trade and investment barriers identified within each of the sectors and shows Partial Equilibrium model-based estimates of the costs of lost opportunities for European exporters. Based on 2004 data for all the manufacturing sectors covered in this study, European exporters of traded goods alone faced an estimated total of €12.4 billion (US\$ 14.6 billion) in 2004 in lost export opportunities as a direct result of non-tariff barriers (NTBs) in China. All calculations were based on 2004 data. In services, loss opportunities in the sectors covered are estimated at €8.9 billion (US\$ 11 billion) in 2005. Highlights of NTBs encountered are listed below and details are available in each sector report.

The sector specific studies use a less aggregated approach by discussing these market access obstacles individually. In addition to using partial equilibrium model based estimates in the sector specific studies (excluding Telecommunications – see notes below); the costs due to lost business opportunities resulting from market obstacles were also quantified on the basis of the qualitative information derived from industry questionnaires. **The relative size of the NTB costs between sectors is in part due to market size** (as measured by imports + domestic output) **and the severity of market access obstacles for each of the sectors.**

**Table 1: Summary of Market Obstacles and their Quantitative Impact<sup>(1)</sup>**

	Machinery	Chemicals	Autos	Pharma	ICT Eq.	Agricult'r	Fin Serv	Distrib't'n	Constr'tion	Telecom	Sustain
<b>Operating Practices not in Spirit of WTO Commitments</b>	•	0	•	•	•	0	0	0	•	•	•
- <i>De facto</i> local content requirements	0	-	•	-	0	-	-	-	•	-	0
- Lack of implementing regulations	-	-	-	0	-	-	0	-	0	•	0
- Gov'mnt procurement preference local bidders	•	-	-	•	0	-	0	-	•	-	0
- Lack of Enforcement IPR	0	0	•	•	•	0	-	0	-	-	•
<b>Economic Patriotism</b>	•	•	•	•	•	0	•	0	•	•	•
- Ownership restrictions	0	0	•	-	-	-	•	0	•	•	0
- (Indirect) Subsidies to Chinese industry	•	0	0	0	0	0	•	-	•	•	0
- Local protectionism	•	-	•	0	0	-	0	-	•	-	0
- Local standards and certification requirements	•	•	•	•	•	0	0	-	•	•	0
- Regulations not applied uniformly	•	•	•	•	•	0	•	0	•	•	•
Cost Due to Lost Business Opportunities <sup>(2)</sup> (\$ '000/ pa)	<b>6,986,024</b>	<b>379,302<sup>(3)</sup></b>	<b>4,619,500</b>	<b>416,289</b>	<b>1,490,024</b>	<b>750,602<sup>(4)</sup></b>	<b>679,000</b>	(5)	<b>5,227,005</b>	<b>5,098,247</b>	(6)
<b>• = Applicable to All Sub-sectors; 0 = Applicable to Selected Sub-sectors; - = Not Applicable</b>											

Notes: (1) This Summary Table provides a comparative overview of the key findings of this study. The qualitative overview of market access obstacles represented here by the black and white "dots", are based on the findings of the sector-specific studies. Unless otherwise stated, the quantitative estimates of the cost of market obstacles were derived by applying a partial equilibrium model with reference to the findings of the sector-specific studies (for full details please refer to the Technical Appendix).

(2) The figures listed apply to the costs of NTBs only and are on an annual basis only, unless otherwise stated.

(3) Due to the high logistics costs involved in transporting Chemicals, the global chemicals industry has a distinctly regional character. This limits somewhat the benefits that could accrue to EU Chemicals manufacturers vis-à-vis other sectors should trade be liberalised. This does not mean however, that existing market access obstacles to trade in the Chemicals sector are negligible as for many EU Chemicals producers they are an important restraint to fully take advantage of Chinese market potential.

(4) Due to the importance of out-of quota tariffs on the impact on agricultural exports (in many cases high out-of quota tariffs block access completely) this figure takes the cost of tariffs as well as NTBs into account. For an overview of how out-of quota tariffs are allocated, please refer to Annex 1 in the Agriculture study.

(5) Although some market obstacles still exist in the distribution sector, general feedback from industry suggests that there is a large degree of goodwill from the Chinese government in allowing foreign participation in this sector. For these reasons, a detailed quantitative cost assessment of market obstacles in this sector was not made, and is estimated to be low.

(6) As a relatively new sector, particular difficulties exist in defining a stand-alone sustainable technologies and services sector not least due to its extensive cross-sectoral application. This prevents a quantification of market access obstacles. Instead, the costs of market obstacles incurred in other sectors can be said, to a higher or lesser degree, to apply to sustainable technologies or services within these sectors as well.

For example, the Chinese Pharmaceutical market scored highly in terms of the severity of market access obstacles (e.g. IP Infringement, Technical Barriers to Trade, Pricing and Reimbursement Policies), but due to the relatively small size of the Chinese Pharmaceuticals market (including moderately low demand elasticities) the absolute costs incurred due to lost business opportunities are relatively lower. By comparison the cost to the European Automotive sector, which overall suffers from slightly lower market access obstacles to the Chinese market, is far higher (about ten times) due to a larger market size combined with higher expected demand elasticities for lower priced and more easily available foreign cars and car parts.

In manufacturing sectors where significant NTB costs exist, such as Machinery and Automotives and, to a lesser extent, ICT equipment, costs are largely derived from IP related losses and impacts, investment restrictions, and through the use of subsidies for Chinese operators which erode operating margins. Government procurement practices are also significant, weighing most heavily on the construction sector where, in addition, costs are also derived from complicated local regulations for foreign operators. The costs derived from local standards requirements remain a feature of all these sectors. Overall, the economic losses associated with investment restrictions and market access blockage (e.g. Telecommunications and Financial Services) are most difficult to estimate, given trade flows are limited in these sectors.

## **B. The role of Chinese Industrial Policies creates a complex mix of “behind the border” barriers**

**Industrial policies** driven by an activist state have shaped the evolution of nearly **all** of the Chinese sectors reviewed, particularly those deemed ‘strategic’ sectors wherein state firms receive preferential treatment from the Chinese government. Many of these policies result in unequal treatment of European operators in manufacturing sectors ranging from machinery and automotive, to services like construction, finance, and telecoms. Given the importance that China’s recent socio-economic reform and industrial policies have had on the competitive environment in China, this section places the various trade and investment barriers identified in the sectoral studies within the wider context of China’s industrial policy. It aims to explain some of the longer-term issues which underlie the trade and investment challenges faced by European industry and outlines likely trends for the mid-term future.

The economic success of a number of Asian economies over the last half-century is often attributed to the roles played by governments active in promoting industrial development. China, a relatively late developer, is no exception in this regard. Significant similarities between China’s growth path and that of its neighbours can be identified. In the hope that one day the successes of South Korea and Japan can be emulated, the manufactured export-driven model has been the subject of much of the economic literature produced in China. To a very large extent, the emulation of these successes has already taken place.

### ***State Interventionism Dominates the Competitive Landscape***

**Substantial subsidies**, disbursed through various forms, create a “soft budget” environment for State-owned Enterprises (SOEs) where bankruptcies rarely occur and business strategies are often based on political considerations e.g. employment or energy security, rather than commercial ones. Poor loan-risk assessment by domestic banks creates highly volatile markets where large margins are followed by a flood of investment and subsequent overcapacity, driving prices down. For example, the total net earnings of the top 30 auto producers in China increased by 45.2% from 2003 to 2004 but profits in the industry fell by 6% during that time.

**Equity restrictions on foreign investment** are prevalent in a multitude of sectors as China attempts to strengthen its own firms, particularly in the so-called strategic sectors. While foreign investors are limited to a non-controlling stake in sectors such as telecoms and automotive, others, such as power generation, are entirely off-limits. Where equity restrictions are not a problem, local content requirements also create disincentives for foreign investors. “Despite wind energy equipment being listed as “encouraged” under China’s foreign investment regime, the 80% local content requirements, which are not compatible with WTO commitments, inhibit our market activities.” [Sustainable Technologies and Services Survey].


There are however a number of factors, both internal and external, which distinguish China’s industrial policy from that of its neighbours. The international economic order into which China is

making its entry is largely different from that of the 50s, 60s and 70s, when South Korean and Japanese industries were establishing themselves in the global trading arena. Multilateral rules governing international trade and investment are today far more sophisticated than they were in the mid-late 20<sup>th</sup> century, and the large body of obligations, such as those under the WTO, have left Chinese authorities with less space to manoeuvre.

The result of these obligations is that any protection that China can give to its domestic industry must take place in the form of “behind-the-border” barriers. This is markedly different to tariff protection which was one of the main tools used by Japanese and South Korean economic planners. These barriers, however, still provide for considerable room to manoeuvre. The range of policy instruments vary from selective public procurement, state-sanctioned dissemination of unlicensed IP, investment restrictions, local content requirements, subsidies and other forms of financial incentives. It is therefore of little surprise that the previous two annual reports published by the WTO focus on domestic regulation and subsidies.

Contrary to common perception, however, there exists little evidence of a nationally orchestrated effort by the central government to protect and promote the interests of indigenous industry as a whole. Many of the barriers identified in the sectoral studies are the result of fragmented action on the part of insubordinate local governments. The following sections will examine in more detail the internal factors, which have shaped China’s industrial policies.

#### **Government procurement often remains opaque and discriminatory**


 **Missed Opportunities for European Operators;** In 2004, direct government procurement accounted for about 1.3% of China’s GDP. However public spending stood at approx 15% of GDP. This results in a large unexplored ‘grey area’ where public spending can be allocated to favoured local bidders. “I called a local government bureau to ask for information relating to a recently-published tender. The response I received was that I had better not waste my time bidding for the project. Oh well, at least the tender was publicised!” [[Construction Industry Survey](#)].

#### **Fragmented and Decentralised**

A seemingly obvious but often overlooked factor to consider when assessing China’s economy is the sheer size of the country. Policymaking in a country comprising 1.3 bn people is inevitably complex and a high degree of decentralisation is necessary, often making the enforcement of central-level directives problematic. While 74% of government expenditure is disbursed at the local level, Beijing collects over 50% of tax revenues, and hence regular budgetary battles also lead local governments to look for sources of “alternative revenue”.

The problem was especially apparent during the central government campaign of 2004 aimed at reigning in credit growth because of concerns of “overheating” in certain sectors. Administrative measures were taken to clamp down on bank lending. Credit growth at the central level slowed to some 12%, while local lending continued to grow at over 60%. The root of the problem is often found in corruption, and is compounded by the lack of an effective judicial system. In such a context, the uniform implementation of WTO commitments nationwide is invariably problematic. Ministry of Commerce officials often struggle to obtain compliance at the local level for the negotiated commitments, particularly when the implementation of commitments will directly impinge upon the vested interests of local officials.


#### **Provincial Trade Barriers**

 “In many senses, China can be viewed as a **kaleidoscope of different regulatory regimes** and expanding into a different region is almost as difficult as expanding into a completely new market. Local protectionism will remain a major problem in the pharmaceutical industry” [[Pharmaceuticals Industry Survey](#)].

Local protectionism can to a large extent be attributed to China’s size but more importantly, to the highly fragmented nature of industry in China. Highly-concentrated industrial structures in South Korea and Japan, dominated by large conglomerates (*chaebol* and *keiretsu*), allowed cabinet ministers and senior strategic planners to coordinate the greater part of industrial output with trade and financial policies. The industrial structures inherited by China’s current leaders make this type of policy making unfeasible.

Rather, the result has been small-scale industrial policy activism by local officials, down to the village level. The command economy left local party chiefs with considerable power to supervise nearly all aspects of commercial life, and hence the support and in many cases the complicity, of officials has become an indispensable factor for successful entrepreneurship in China. Through tax revenues or even direct shareholding, the line between the regulators and businessmen is often blurred to the detriment of the Chinese “single market”.

#### **Local Level Protectionism**

 **The close links between Chinese regulators and SOEs** and between provincial governments and local enterprises leads to issues of **transparency** where foreign companies can in effect be regulated by their competitors. For instance, in many sectors, regulators tend to find a pretext for accessing crucial information on the operations of foreign companies in order to assimilate their technical capacities. “We easily meet or exceed government regulations; however we suspect that the occurrence of regulators frequently checking our books is a ploy to see first-hand how a proper bank branch is run and to observe best practice. This is difficult to prove but clearly constitutes unequal treatment and should be faced by severe sanctions.” [Financial Services Survey].


That is not to deny the existence of a centrally-coordinated industrial policy altogether. However, rather than coordinating national production, the central government has chosen to “strategically” focus on a handful of selected sectors and firms. In order to do so, a large consolidation process is already underway to merge the larger State-Owned Enterprises and privatise the smaller ones.

#### **Home-grown Innovation**


During the Mao era, an obsessive focus on technology and the development of productive forces laid the foundation for China to train, with Soviet assistance, a vast army of engineers. A large majority of central government officials hence hold educational backgrounds in engineering, rather than in law or economics as is the case in most western administrations. Given this background, recognition came early on in China’s reform process that closing the technology gap with the west was a priority.

Hence, the notion of using the lure of access to the vast domestic market as a bargaining chip for technology was conceived. FDI contracts – often negotiated by or in the presence of government officials – usually contain provisions for technology transfer and training. The joint-venture model allowed indigenous companies to learn management techniques from their partners and absorb their production technologies. Local content rules obliged investors to manufacture and train their workforces in China. Additionally, lax enforcement of IP laws allowed technology to be disseminated at a rapid rate.

#### **IP Protection: A Real Concern**

 **Lax IP enforcement:** The drive to boost innovation in China has resulted in various forms of policies to accelerate technology development and diffusion in order to reach a state of technological self-sufficiency. First and foremost lax IP enforcement and a significant degree of infringement remains a serious problem for all European sector operators in China. It not only erodes the value of IP-holders’ assets, but can also have serious health and safety implications, for instance in the case of counterfeit pharmaceuticals

Rampant patent infringement has to a large extent discouraged some foreign investors from manufacturing core components in China, not to mention localising R&D. “We do not perform actual projects ourselves among other things because we have experienced copying by former employees of a partner company, who now use this technology freely and even claim to have invented our technology.” [Sustainable Technologies and Services Survey].

 **A culture of IP acquisition:** Chinese operators have benefited greatly from aggressive acquisition of foreign IP, often through technology transfer obligations and joint-venture requirements. Due to low industry profitability, most Chinese manufacturers cannot afford to invest in R&D (est. to be less than 1% turnover). Product development efforts are therefore often limited to re-engineering of advanced foreign machinery. This is especially apparent in the automotive sector. “Chinese manufacturers are copying finished cars. They are also copying car components. This is very dangerous for the consumers and it is an increasing trend.” [Automotive Industry Survey].

More recently, however, the focus has turned to “home grown innovation” as China’s priorities seem to have shifted from absorbing technology to reducing dependence on foreign technologies, creating a form of technology import substitution. Priority areas for government support are mainly in hi-tech sectors such as semiconductors and Integrated Circuits. Policy instruments therefore range from the provision of direct financial support for R&D to the imposition of home-grown certification and standards.

In order to bolster domestic innovative capacity, a number of new policies have emerged in recent years which make the approval of new foreign-invested manufacturing facilities conditional upon the establishment of a local R&D centre. After a considerable amount of objections being raised, many foreign companies are now falling in line with the new policies for fear of falling out of favour with their regulators. R&D localisation policies are also part of the package aimed at boosting domestically added value for exports. On average, some 75% of the value of China’s exports, whether in product design or core components, is imported. The remaining 25% is often provided locally through packaging and assembly.

The drive for home grown innovation has thrown the question of IP enforcement into the limelight and strengthening IP enforcement has received an increasing amount of attention in the speeches of senior officials. Yet, Chinese officials seem to be in two minds on IP. On one hand, cracking down on infringement would result in the destruction of a large number of jobs, put a brake on the diffusion of technologies and drive prices up. On the other hand, turning innovation into a source of value creation, rather than an added cost of production, is impossible without IP protection. For the moment, the driving principle in China seems to be a rather static one of haves and have-nots: Those who have IP should protect it, while those who don’t have it have no reason to protect it. Hence, in the drive to build an innovative economy, China is still currently following an “everything but IP” policy.

### **The Legacy of State Planning**

While the proliferation of market forces has catapulted the Chinese economy forward, there is little talk of political reform, and it is becoming increasingly clear that the political and administrative machinery has failed to keep up with the pace of economic change. Despite some incremental improvements and cosmetic changes, much of the old planning apparatus still remains in place. The Five-Year Plan still remains the most important document in guiding the economy. While it has been renamed the Five-Year Programme (FYP) and no longer makes use of hard targets such as GDP growth, the FYP spawns a plethora of sectoral plans rife with targets such as production, export, consolidation, technology, etc.

The result of the planning, often poorly done, is that markets tend to swing back and forth between shortage and surplus, to the detriment of the domestic and international economy. The typical scenario is that some shortage of some utility or commodity emerges due to lack of foresight by planning officials, which is then followed by a flood of investment fuelled by zero- or low-interest credit from state policy banks, which finally results in overcapacity and saturation in the domestic market, a flood of exports and a subsequent dive in global commodity prices.

At the central level, the chains of command are difficult to discern. Various line ministries exercise overlapping competencies with horizontal ministries, partly due to opaque institutional restructuring. For instance, a closer look at “industry associations” in China reveals that they are actually former sectoral planning departments of government agencies which have received a superficial makeover. The “association” employees are actually still on the government payroll and are still responsible for drafting various industrial plans. As a part of China’s WTO commitments, the State Economic and Trade Commission, responsible for domestic commerce, was subsumed by both the Ministry of Commerce and the National Development and Reform Commission (formerly the State Planning Commission). As a result, a glance at the organigrammes of either ministry can be a confusing exercise. Within the NDRC, there exists both a Department of Price and Department of Price Supervision, and a Department of Industry as well as a Department of Industrial Policy. The precise function of either department is not entirely clear.

There are a number of administrative divisions which have been made redundant as a result of liberalisation (for instance the Office of National Economic Mobilisation). Yet they continue to exist and, suffering an existential crisis, strive to find a role in today’s China. The result is that, once in a while, a bizarre regulation is issued in the search of a new role. At the same time, very powerful ministries continue to exist, despite having little role to play in a market-oriented economy. The NDRC, which exercises control over virtually all aspects of industry, is a case in point. Finding an appropriate role for these entrenched bureaucracies and gathering enough political capital to push through the necessary institutional reforms remains a key challenge for China’s political leaders.

## **Navigating the Path of Reform**

The opaqueness of Chinese politics does much to conceal the precariousness of the positions of the top leadership. International media coverage makes it easy for an observer to conclude that absolute power is concentrated in the hands of a few Politburo members, who are able to push whatever reforms they deem desirable through the system with relative ease. This is hardly the case; party politics is replaced by private factional politics, which in turn is heavily dominated by regional power struggles. Moreover, the need to preserve political and social stability in a country brimming over with rural unrest creates a very fine tightrope indeed for any Chinese leader to walk. Moreover, the entrenched bureaucracies in Beijing have exhibited a rock-like resistance to head-on change. It is little wonder that a successful reformer in China is therefore said to be one who masters the tactic of “signalling left, while turning right”.

An emerging phenomenon which has recently thrown the entire reform process into question is the issue of growing income disparities between the urban coastal regions and the rural inland regions. Roughly two-thirds of China’s population has been largely excluded from reaping the benefits of reform, which has resulted in rising rural unrest, manifested by the sharply increasing number of “mass incidents” in the countryside.

The phenomenon has indirectly contributed to the formulation of policies contrary to the spirit of reform. The government-prescribed solution for rural stagnation and underemployment is a policy mix of lifting the fiscal burden on farmers and integrating the surplus labour into the burgeoning export-driven manufacturing sector through urbanisation, an effort which places massive pressure on authorities to create employment. Any policy actions which are likely to increase short-run employment pressures, such as greater IP protection, phasing out of certain subsidies, SOE privatisation or even enforcement of environmental regulations are therefore viewed as highly undesirable even if they are likely to generate greater growth in the long term.

This policy short-sightedness can to a large extent be attributed to the internal system of incentives for regional officials, whose performances are evaluated on their ability to meet economic targets such as GDP growth, unemployment, exports, etc. During, say, a provincial party secretary’s short tenure (a few years), long-run gains are sacrificed for short-run improvements, which explains for instance why SOE bankruptcies are prevented through state aid or forced acquisition by another SOE, or why so many unrealisable investments are made.


## **2006: China at a Crossroads**

China found itself at a crossroads in its development path in 2006. Nearly three decades of reform and substantial economic growth has come at the expense of balanced and sustainable growth, and inequalities have been exacerbated. The imbalances are recognised in the 11<sup>th</sup> FYP launched in March 2006 which sets out an ambitious blue-print for re-orientating development toward sustainability. There is much at stake for China to achieve its sustainability targets and major challenges remain.

While the Chinese leadership is in agreement on the diagnosis of social and environmental pressures, there is less clear consensus with regard to the prescription. While the official line of the leadership remains to “continue unwaveringly on the path of reform”, there has been little concrete indication of where future reforms are likely to take place. Nonetheless, while some degree of “reform fatigue” has set in, there is evidence to suggest that there remains a genuine belief in the ability of reform to drive growth.

Conservative elements of the Chinese government argue that the inequalities have arisen as a result of excessive reform, which has done little for the vast majority of the population residing in the rural areas. Therefore, they say, a pause and in some extreme cases a reversal of reform is necessary. Recently, they have achieved some victories, for instance in the appearance of regulations tightening restrictions on foreign investment.

### ***The Two Faces of Protectionism***

 The other side of the coin is that for every unfair commercial practice faced by European operators there is also a **negative long-term effect on the competitiveness of Chinese industry**. Subsidies in many cases undermine incentives to boost competitiveness and lead to dependence of domestic operators, as do discriminatory procurement policies. Excessive credit extension results in overcapacity and price wars (auto/machinery/ICT). IPR infringement disincentives innovation, destroys brand value at home and erodes foreign investor confidence. Chinese “home-grown standards” and compliance requirements can result in obstacles for Chinese companies in penetrating overseas markets. Corruption impacts China’s most competitive companies. Altogether, NTBs create a difficult environment for Chinese entrepreneurs to flourish.

“Despite the frustration of foreign investors, many take a sympathetic view. One representative commented, “It is likely to evolve in the right direction. China is going through a kind of patriotic/nationalist phase that has occurred in every country anyway. We need to give them time to understand the value of win-win cooperation with foreigners.” [Machinery Survey].

Liberals on the other hand maintain that continuing reform will be the only way to generate enough growth to spread the benefits more widely. They recognise that liberalisation has been key in boosting productivity and modernising Chinese industry, and that the country is too large and fragmented to be supervised and planned in great detail from Beijing. Moreover, corruption is rife among local officials, and the most effective way to prevent abuse of powers is invariably to reduce those powers through further liberalisation. On the environmental front, the entanglement of regional officials with local enterprise has resulted in poor enforcement of environmental standards, which is to a large extent the cause of decimation of the natural landscape and loss of biodiversity. Reform, too, has a role to play in this regard. Encouraging investment in environmentally-friendly industries and freeing markets from the control of vested interests could greatly reduce some of the stresses on China’s environment.

As China nears the end of the transition period to implement its WTO commitments, some serious consideration needs to be given to where the next series of reforms will go. Economic reform since 2001 has effectively been on auto-pilot with the WTO commitments schedule serving as the roadmap. If the Doha round fails, China’s leaders will need to get back in the driving seat. While there has been some talk of services liberalisation and further liberalisation of the capital account, more fundamental changes in China’s economic governance structures are needed to facilitate the development of the market economy. Perhaps it will take an economic slowdown for serious reform to become a top priority again.

## **IV. RECOMMENDATIONS**

The following section provides recommendations for policymakers and industry, highlighting some of the opportunities and suggesting effective approaches for the EU to conduct its economic relations with China. The recommendations are structured in the following way:

- Overall recommendations on the EU’s trade relations with China
- Recommendations on trade policy by trade issue
- Recommendations on trade policy by sector

### **A. Overall recommendations**


#### **1. Strengthen high-level dialogue on strategic economic issues:**

- i. Establishment of an economic working group at the Commissioner/Vice Premier level, bringing together various DGs and ministries under the European Commission and the Chinese government. Senior political figures from EU Member States should also participate.
- ii. Issues for discussion should revolve around the future of the EU and Chinese economies. Plans for reform and the transition to more sustainable growth patterns should be a central theme, as well as the role played by the EU and China in the global economy. Both sides should share views on internal dynamics in order to enhance mutual understanding

of internal problems faced, and discuss ways through which bilateral trade and investment can play a constructive role in the process.

- iii. The high-level working group should provide guidance to the various EU-China dialogues relating to economic reform. There are currently a number of distinct EU-China dialogues covering various issues relating to socio-economic reform and sustainable development, however, little coordination exists between the dialogues.

#### ***EU-China Trade Relations: working towards a win-win approach***

 **EU-China negotiations on a Partnership and Cooperation Agreement (PCA)** were launched toward the end of 2006. The Agreement will include an update of the 1985 Trade and Economic Cooperation Agreement. However, both sides enter these negotiations with significantly different expectations.

The dominant EU view is that the honeymoon period of transitional privileges under the terms of WTO accession is over and China needs to move faster in removing NTBs and improving market access towards a Doha-plus agenda. The dominant Chinese view is one of “reform fatigue”, reluctance to contemplate new commitments and preference to proceed very cautiously with reform for fear of its consequences on employment and social stability.

The establishment of common ground on the future direction of reform in China and the constructive role which the EU can play in this context is key to movement on these issues. While trade and investment barriers are high on the agenda of EU-China relations, they should not inhibit engagement on broader, long-term issues where much is at stake. Improvement in the overall situation with NTBs and other barriers will only come through deepened reform, a process which the EU should encourage and support.

### **2. Enhance awareness of risks associated with investing in China:**

- i. The allure of the world’s largest potential market has often led to quick investment decisions which have not taken relevant risks such as IP infringement into account. Establishment of a risk monitoring body to alert European investors to potential hazards and of ways to mitigate these risks would be valuable particularly to SME investors who do not have risk assessment teams at their disposal. The information collected by the body, assisted by Member State embassies and on the ground European trade associations should be targeted at senior management and boards of European companies with an interest in China. In the current climate of ‘good governance’ private sector operators will find the lists of potential hazards important information when structuring investment decisions. Dissemination could also be supported by Member State government departments, trade delegations in China and European trade associations.
- ii. The fragmented/regional nature of the Chinese market often leads to region specific barriers. The work of the monitoring body should be sensitive to such differences and provide regional breakdowns of investment risks.
- iii. Such a body would, in addition to helping to identify risks for European investors, provide an added incentive for local governments in China to improve their business environments with a view to attracting more foreign investment.

### **3. Enhance the coherence of the “EU voice”:**

- i. Coordinating divergent views among Member States over trade policy is essential. In their bilateral relations with China, Member States will not always communicate the same views on the economic relationship, thereby sending mixed signals on the overall EU position.
- ii. Coordination among non-governmental and civil society bodies in Member States, such as standards organisations, industry associations etc. should also be enhanced. Currently, different policy/regulatory positions, sometimes even contradictory positions, are being advocated. Such representation could take place in the form of umbrella organisations bringing multiple associations/standards bodies together.

#### **4. Expand the EU presence in China:**

- i. An expansion of the Commission's presence in China could be of great value, particularly in dealing with the multitude of regional issues in China. As a start, more Commission trade officials should be sent to China (there are currently three), and EC Delegation offices should be opened in Shanghai and Guangdong province. A placement of Member States trade officials in EU Delegations on a rotational basis might be considered.

#### **5. Step up efforts to meet the goals of the Lisbon Agenda:**

- i. Trade and investment barriers faced abroad should not divert attention from the pressing issue of domestic reform. Ultimately, the most important factor of competitiveness in Europe is a domestic regulatory environment which fosters entrepreneurialism and innovation.
- ii. Reallocating resources away from uncompetitive, labour-intensive industry into the high-value added knowledge economy will also enhance the complementarities of the European and Chinese economy and reduce trade friction.

### **B. Trade Policy Recommendations by Trade Issue**

1. Monitor China's implementation of its IP Action Plan and other IP commitments in the form of comprehensively designed industry questionnaires and thematic studies.
2. 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.
3. 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.
4. Encourage China to adopt existing international standards and build mutual recognition of its national standards where possible.
5. Leverage growing competition for FDI from other emerging economies e.g. India, ASEAN members, to negotiate forms of investment which are 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.
6. Engage in dialogue on the use of subsidies which distort trade and make use of anti-subsidy provision under the WTO where necessary.
7. Emphasise the importance of independent regulation of industry through separation of regulatory and business functions, and administrative reform.
8. Ensure that technical assistance (TA) is provided in areas deemed of strategic priority for both sides and that TA is closely coordinated with policy action.

### **C. Trade Policy Recommendations by Sector**

1. ***Machinery*** – Encourage adoption of transparent public procurement in China and elimination of subsidy policies.
2. ***Chemicals*** – Encourage adoption of intermediate notification requirements in line with common practice in most jurisdictions. Current data requirements in China are highly restrictive due to the lack of differentiation at lower levels.
3. ***Automotives*** – For auto parts, emphasise that China's Compulsory Certification requirements duplicate international certification practices. For finished vehicles, capital requirements for auto-financing by non-financial institutions are excessively high.

4. **Pharmaceuticals** - Request clarification on pricing policies in order to ensure they are based on transparent, predictable and non-discriminatory criteria. IP infringement also remains a serious problem.
5. **ICT** – Ensure that indigenous standards are not imposed in place of internationally-recognised ones. IP infringement and subsidies are problematic.
6. **Agriculture** – Negotiate timely removal of SPS measures and provide better access to information on SPS measures and on third country import guidelines by improving the administration of the EU market access database.
7. **Financial Services** - For the banking sector, negotiate further reductions in capital requirements – more specifically abolish the mandatory working capital deposit of 30% - bringing it in line with international practice. For the insurance sector, encourage China to grant licences for operations in new provinces to life insurance companies with foreign participation. This will allow nationwide competition on an equal footing with Chinese life insurance companies.
8. **Distribution and Retail** - Negotiate a non-discriminatory approval regime for the establishment of new outlets for foreign retailers and enhance methodologies for assessing community impacts of trade defence actions.
9. **Construction** - Negotiate permission for 'registered foreign contractors' to provide construction related services, as was the case under Decree 32 prior to China's accession to the WTO.
10. **Telecommunications Value-added Services** – Request clarification of the upcoming Telecommunications Law and stress the importance of reducing regulatory risk. China must open this market in line with WTO commitments.