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An EU-China trade dialogue: a new policy framework to contain deteriorating trade relations

Iana Dreyer and Fredrik Erixon
Iana Dreyer (iana.dreyer@ecipe.org) is a Trade Policy Analyst at ECIPE and
Fredrik Erixon (fredrik.erixon@ecipe.org) is a Director and co-Founder of ECIPE

Economic relations between Europe and China have deteriorated. Last autumn, frustrated by Europe's soaring bilateral trade deficit with China and its alleged currency manipulation, EU Trade Commissioner Peter Mandelson altered the tone and the language of EU's official rhetoric towards China. Before the EU October summit – a summit at which President Nicolas Sarkozy and Chancellor Angela Merkel called for new measures to be taken against China – Mandelson spoke about the EU's growing trade deficit with China as a "policy time bomb" and warned China against continuing its exchange-rate policy. Later, in Beijing, the EU trade chief expressed support for an increasing use of antidumping tariffs against China if it did not take appropriate measures to lower its surplus with Europe. He also hinted that litigations against China in the World Trade Organization (WTO) would become more frequent. Using the image of a vicious fiction character, Mandelson said that China behaved like a "juggernaut" in the world economy.

In China itself, nationalist and protectionist reactions against foreign criticism and foreign investment have been on the rise. Beijing finds it increasingly difficult to address rising nationalism. This affects China's

SUMMARY

EU-China trade and economic relations have deteriorated. The rhetoric has become tougher on both sides, and the EU has imported the culture of "China bashing" from U S politics. Increasingly hostile rhetoric and the danger of tit-for-tat protectionism are reason enough to establish a new process for bilateral trade relations that can contain perilous rhetoric and policy.

This Policy Brief assesses the opportunities to improve the souring economic relations between Europe and China, offered by a new initiative to solve commercial problems and negotiate deeper integration: the EU-China High Level Trade and Economic Dialogue. The Dialogue was proposed in 2007, and the format is to be announced in late April.

Drawing conclusions from a parallel U S-China Strategic Economic Dialogue, this study analyses the risks and constraints under which the new EU-China Dialogue will operate. Europe's institutional complexity in particular is a major challenge. For this new bilateral forum to yield results, several conditions will have to be met. The agenda must be clear from the beginning; the issues causing the bilateral frictions should form the core of the agenda. Both parties must show restraint; the agenda must not be overloaded and they should avoid introducing new regulations restricting trade. Political backing from EU member states, and more targeted input from the business community will also be necessary.

dealings with other countries. China's unprecedented programme of root-and-branch trade and investment liberalization has slowed down considerably. Foreign economic policy is increasingly tied up in domestic politics – and domestic politics are becoming ever more complicated. China has also introduced protective measures. New and sudden tariff increases, which were recently ruled against by a WTO panel, and new registration and certification requirements discriminating against foreign firms, contrast against the previous era of autonomous liberalization.

Increased use of the WTO dispute settlement system is neither an expression of protectionism nor a cause for alarm. Yet EU-China economic relations are in danger of sliding into protectionist policy. Hostile rhetoric alone – and the concomitant neglect of all the extraordinarily good news in EU-China trade – are reason enough to reflect upon the chosen strategies. It also reinforces instinctive biases against further liberalization and thus holds the EU and China back from deepening its commercial integration by further market openings. Worse still, tit-for-tat protectionism may be around the corner.

The timing of currently increasing hostilities is unfortunate. Europe and China are planning to start negotiations on a Partnership and Cooperation Agreement (PCA) in order to update the framework of their commercial relationship, which is currently based on the 1985 Trade and Economic Cooperation Agreement (TECA). Although a Free Trade Agreement (FTA) between EU and China has never been on the cards, trade authorities on both sides have high hopes of improved commercial relations.

In the midst of rising tensions, the last EU-China Summit in November 2007 announced the launch of a High Level Economic and Trade Dialogue in a move to bring both sides to the discussion table[1]. Europe's Trade Commissioner and China's Commerce Minister are due to propose its format in late April 2008 when a big EU delegation visits China.

Inspired by the U S-China Strategic Economic Dialogue (SED) set up by the end of 2006, the EU-China dialogue aims at forming joint strategies of bilateral economic relations and at facilitating concrete commercial negotiations. However, in today's increasingly hostile atmosphere, it is difficult to see how the EU-China Dialogue could meet high expectations. Moreover, as the two parties have not yet provided any distinct intent and direction, there is a risk that the dialogue meetings become talking shops leading to nowhere. Worse still, empty talkfests could damage the chances of solid, sober, and constructive negotiations over the upgraded commercial agreement and the PCA.

Against the backdrop of deteriorating EU-China trade politics, this Policy Brief analyses the prospects for the proposed EU-China High Level Economic and Trade Dialogue. It discusses the institutional setting and how to put it to work and effectively support further integration and market-access liberalization. Our outlook is deliberately "Eurocentric": the paper primarily analyses ambitions, constraints and policies in Europe. Furthermore, the paper intends to assess the validity of a Dialogue approach to address protectionist pressures, not to scrutinize the merits of certain policies.[2] Drawing on the experience of the U S-China SED, this paper also sets out an agenda focused on the commercial issues that feasibly can be addressed in this new Dialogue.

1. THE ISSUES AT STAKE

The launch of the EU-China High Level Economic and Trade Dialogue comes at a moment of rising tensions over further economic integration between two of the world's major economies. Europe is China's main trading partner. China has quickly risen to the rank of Europe's second largest trading partner in goods, and fourth largest in services, since it joined the World Trade Organization (WTO) in 2001. There are frustrations on both sides. Europe's frustrations stem from the perception that it is losing ground in China amidst a soaring bilateral trade deficit. China feels Europe is not appropriately appreciating a mutually beneficial relationship and is frustrated over the recurring calls for protective measures.

Commercial policy disagreements

Europe's trade deficit with China has increased rapidly in the last years, rising from roughly 50 billion EUR in 2001 to around 170 billion EUR in 2006, a more than threefold increase. The deficit keeps growing and is projected to rise well above 200 billion EUR in 2008, which can be compared to the U S bilateral trade deficit with China of 256 billion USD in 2007. However, there is one central difference between the U S and the EU current accounts: the EU has a negligible overall deficit (around 0.5 percent of GDP in EU-27), while the U S current account deficit still hovers around 700 billion U S dollars (around 5-6 percent of GDP for 2007).

Europe faces real market-access problems in China. These are slightly reflected in the fact that exports to China have not risen as dramatically as imports from China, despite an impressive increase of 82 % in four years between 2002 and 2006.[3] In several areas where European businesses are competitive, they are confronted with market-access problems. Europe represents 8 percent of FDI in China, and feels this figure is way below potential. It is faced with difficult investment conditions in general. This is especially the case for investment regulations in China's services, in particular financial services.[4] Ineffective enforcement of key intellectual property rights, and the entire issue of forced technology transfers, are big concerns, especially in sectors with high rates of innovation. Furthermore, China has developed its own technical standards and introduced new elements of discriminatory treatment in issues such as registration and certification requirements. Lax disciplines on subsidies to domestic firms also damage European firms active in China.

China, for its part, faces protectionist pressures from Europe. It is Europe's main target in antidumping actions, with more than forty cases in place, and feels that its companies are not fairly treated in EU's anti-dumping investigations. In 2007, a year of restraint in the launch of such investigations, China was highly represented in EU's trade-remedy activities. Chinese companies were involved in all six new anti-dumping investigations (in only one case were companies from other countries involved). Of the six investigations that in 2007 concluded with the imposition of provisional duties, Chinese companies figured in four. Of the eight new investigations that the same year concluded with the imposition of definite duties, Chinese firms were involved in seven.[5]

In 2008 a number of new anti-dumping cases against Chinese exports have been opened, concerning goods such as candles and steel. In opposition to its own anti-dumping assessment and the result of a consultative member-state vote, the Commission recently overruled the recommendation of <u>not</u> imposing punitive tariffs on air compressors, some of which are from China. Now a new anti-dumping tariff will be introduced.

China wants greater disciplines in EU's use of trade defence instruments and also demands Market Economy Status (MES) from Europe. According to the WTO accession protocol, Europe is entitled to withhold this status until 2015. Yet the decision not to grant China MES is perceived as very political. For example, the EU decided at the end of 2002 to grant this status to Russia, which is not yet even a member of the WTO, and which has controversial market economy credentials when compared to China.

Other concerns revolve around "peak tariffs" in some manufacturing goods, and Europe's stringent Sanitary and Phytosanitary Standards, REACH and other regulations that deviate from international standards and raise barriers to trade. These are often perceived as tools of hidden protectionism. Furthermore, as China is becoming an international investor, it requests improved access and non-discriminatory rules for sovereign wealth funds as well as for private investors. Concerns over investment protection in Europe have grown stronger after headline cases of discriminatory interventions by governments in affairs concerning foreign investments and takeovers, and after introduction of new regulations in matters of mergers and acquisitions. Finally China also wishes lower barriers in agriculture for its increasingly outward orientated farmers.

An inadequate institutional framework to address rising commercial concerns

This list of trade-policy concerns on the both sides shows that there is a great potential in deepening trade and investment integration between Europe and China. Yet tensions have arisen. The current setup to handle bilateral commercial relations does not function properly. Although China and the EU agreed on a Strategic Partnership in 2003, and have been meeting annually at the highest level for a decade, this has not hindered increasing frictions in trade relations. Nor has all the Committee work between the two yielded satisfactory results. More than twenty sector-specific dialogues and working groups are in place, but they have fizzled out or turned into talking shops when political backing has not been there. EU member states for their part play their own, often competing, strategies in China, which has complicated the game. Beyond the rising role of national governments in striking export deals with the Chinese government, of particular interest are the twenty bilateral investment treaties signed by the majority of member states with China are of particular interest. Some of these BITs, such as the United Kingdom's or France's, date as far back as the mid 1980s and would need an update. Germany recently concluded a new BIT with China, and others are to follow. In Brussels there is a belief that the new Lisbon Treaty, if ratified, will centralize investment policy in Europe and make BITs of the member states redundant. If this is a correct interpretation of the Lisbon Treaty remains to be seen. If it is, the EU is likely to soon seek an investment agreement with China.

The need to tackle pressing commercial matters and to improve the institutional framework to smoothen and deepen them makes the creation of the High Level Economic and Trade Mechanism a welcome move. Will it be able to deliver?

2. U S-CHINA STRATEGIC ECONOMIC DIALOGUE

The proposed EU-China Dialogue is clearly inspired by an initiative taken by the United States in late 2006 to tackle a bilateral standoff that was running out of control.[6] Yet, is the U S-China Strategic Economic Dialogue a model to follow for Europe and China? If so, what can the EU and China learn from it?

Background to the SED

The SED was launched in 2006 by the countries' respective heads of state, and continues to function with their full and direct backing. It aims at discussing strategic issues in a medium-to-long-term perspective, but also facilitates concrete commercial and policy negotiations. One top-level government official is in charge of leading the dialogue and he/she reports directly to the head of state. At the outset of the SED, these officials were the U S Secretary of the Treasury, Henry Paulson, and the former Chinese Deputy Premier, Wu Yi, who has been replaced by Zhang Dejiang. The SED meets bi-annually, and is composed of the heads of the relevant ministries or regulatory bodies (commerce, central banks, financial regulators, environment, agriculture, et cetera). A special envoy was nominated by the U S to coordinate and structure the dialogue in between meetings.

A product of Hank Paulson, and born out of his experiences from business dealings with China while heading Goldman Sachs, the SED has been portrayed by some as a talkfest. Yet the politics of Sino-U S trade relations have improved considerably since the launch of the SED. This is due to a variety of factors that go beyond the SED. It has become clear that exchange-rate policy in China does not give sufficient explanations to the bilateral trade deficit, which has continued to soar despite the appreciation of the Chinese currency. Furthermore, recent cases in the WTO have also demonstrated that commercial concerns over China can be addressed in a structured legal manner in the WTO.[7] However, the Dialogue has helped to "calm passions" in the U S Congress and fostered a U S trade and economic policy towards China based on greater rationality and less hostility.

The politics of the United States' trade relations towards China soured soon after China's entry to the WTO. In a 2000 voting, the Senate granted China so-called Permanent Normal Trade Relations (PNTR), a U S law establishing non-discriminatory treatment and greater certainty for non-WTO countries, by a solid majority. The then United States Trade Representative (USTR), Charlene Barshefsky, commented: "Granting PNTR for China not only provides tremendous economic opportunities for U S workers, farmers and businesses, it is also the best way to promote reform in China and stability in the region."[8]

A year later, such a comment seemed alien to the politics of U S trade. After that senate vote, the politics of U S trade relations with China took a protectionist direction. An overtly protectionist bill on U S-China trade was tabled in February 2005 by U S senators Charles Schumer and Lindsey Graham. This bill called for an unprecedented revaluation of the Chinese currency and threatened to slap a 27.5 percent tariff on all Chinese exports to the U S if China did not agree to revaluate its currency at a similar level.[9] Later the same year, the U S Congress blocked an acquisition by China National Offshore Oil Corporation's of the U S oil company Unocal.[10]

Events like these formed the backdrop to the Sino-U S Strategic Economic Dialogue. The increasingly charged atmosphere in the U S Congress called for a new format of discussions and negotiations. China is still subject to much criticism in U S trade politics – especially in an election year. In the Congressional process of the Non-market Economy Trade Remedy Act of 2007, there were flare-ups. A proposal was tabled by Artur Davis (D-Ala) to amend the act to open for considerably more trade-remedy actions, especially anti-subsidy actions. The bill did attract many co-sponsors, and there might be a turn towards increasing use of anti-subsidy duties against China. However, the likelihood of the U S Congress taking draconian measures against Chinese trade is considerably lower today.

Key outcomes

Therefore, "damage limitation" is one key outcome of the Strategic Economic Dialogue. Yet instincts of China bashing, or protectionism, could not have been calmed if the SED were only a talking shop that did not address some of the U S concerns in its trade relations with China. It is wrong to say that there have been strong, substantive, negotiated outcomes of the SED. It is, however, equally wrong to say the results have been weak.

Since the end of 2006, three dialogues have taken place. The methodology of the SED is based on a progressive and pragmatic build-up of a programme and prioritization of topics every six months. For example, at the launch of the SED, food and other product safety standards were not high on the agenda. The third SED, following the crisis earlier in 2007, was strongly dedicated to the matter and achieved concrete results in setting up co-operative product-safety regulatory structures.

Much of the dialogue is about "agreeing to agree", but it helps structure interdependent and sensitive issues. The ongoing discussions are often centred on big-ticket topics, such as trade and macroeconomic imbalances; intellectual property rights; bilateral co-operation on environmental issues; transparency issues; a clear goal of achieving a bilateral investment treaty; the granting to China of market economy status; easing Chinese tourism in the United States; and co-operation in science and technology. Such discussions can yield a better understanding between countries.

However, they can also turn into talking shops of no relevance and practical meaning. Obviously it is good that governments talk to each other. Yet there is an exaggerated belief in what exchange of information can yield. Differences in policy are often due to a lack of motivation of one party to change its policy, not a lack of information about the problem or the view of the other party.

Yet a parallel hands-on, business-like approach has also led to concrete if partial and piecemeal outcomes to open specific markets (see Box 1). The concrete results were achieved in financial services, product safety, environment, aviation. China has received an explicit statement from the U S to avoid protectionism and discriminatory treatment of Chinese investments in the U S, and support of its aspirations to join the Financial Action Task Force (FATF) and the Inter-American Development Bank (IADB).

In the context of this paper, two salient results deserve special elaboration: how financial services have been tackled, and how the U S has raised the political cost of protectionism against China.

Firstly, the SED has led to increased market access in China in sectors of importance to the U S economy, in particular financial services. Even if much remains to be opened in the Chinese financial sector, increased openness in these sectors has addressed the perceived imbalance in U S-China trade: the U S is open to trade based on China's competitive advantage, but China is not equally open to trade in sectors in which the U S has strong competitive advantages. The New York Stock Exchange and NASDAQ have been allowed to open branches in China. U S banks and financial firms have been granted greater opportunities to do business there. Most of the achieved results had been discussed previously, and were supported by other factors, but the SED played a significant role in midwifing the outcomes. Put differently, the SED helped China to weight the political calculus in favour of opening the markets.

Secondly, outcomes from the SED have put opportunity costs on protectionist measures by the United States. If, say, a 27.5 percent tariff was to be introduced now, it would run the risk of leading to Chinese repeals of achieved reforms and blockages of further reforms, which are under way. The sheer fact that the U S has signed a document promising to avoid protectionist measures makes the political calculus clearer. It is naïve to think that such a document rules out protectionist measures, but it raises the cost, and the awareness of the cost, to the United States of introducing such measures.

3. WHAT ARE THE MOTIVATIONS FOR THE EU-CHINA DIALOGUE?

An EU-China Dialogue makes sense. It can build on the China strategy the Commission set out in October 2006,

BOX 1
RESULTS OF U S-CHINA STRATEGIC ECONOMIC DIALOGUE (SED) AS OF END 2007

Examples of specific outcomes that were achieved in targeted sectors

Financial services

- NYSE and NASDAQ allowed to open a branch in China.
- Investors in securities allowed to issue papers in local currency.
- Foreign banks allowed to issue bank cards in local currency.
- Easier branching for foreign insurance companies.
- Licensing of international securities companies resumed.
- Commitment by Chinese authorities to examine further opening of financial markets.

Export safety

- Various memoranda of understanding on food and feed, drugs and medical products, environmentally compliant exports and imports, food safety, alcohol and tobacco products, toys, fireworks, lighters, electrical products, motor vehicle safety, pesticides tolerance and trade.

Environment

- Memorandum of understanding on biomass resources conversion for fuel, illegal logging. China commits to develop and implement a program on SO2 emissions trading, with U S technical assistance

Aviation

- Expansion of U S-China aviation agreement: more flights, liberalization of cargo services as of 2011, negotiations on full liberalization of passenger services to start in 2010.

Tourism

- Agreement to launch Chinese group leisure travel in the U S.

Transport

- China will import U S railway equipment.

Other

- U S commitments on avoiding protectionism and non-discriminatory treatment of Chinese investments in the U S.
- U S supports Chinese aspirations to join FATF and IADB.

Ongoing discussions

- Trade and macroeconomic imbalances.
- Various bilateral issues such as intellectual property rights.
- Innovation.
- Framework of 10 years to handle bilateral co-operation on environmental issues.
- Transparency issues (implementation of WTO commitments among others).
- Stated goal of achieving a bilateral investment treaty.
- Discussions on giving China market economy status.
- Easing Chinese tourism in the United States.
- Co-operation in science and technology.

when Peter Mandelson explicitly referred to the need of "a better quality economic dialogue between the EU and China, and a stronger political mechanism for agreeing matters affecting trade."[11] An EU-China dialogue cannot be an exact replica of the U S-China dialogue, but it can build on the experiences gained from this exercise. Furthermore, one of the key motivations for launching a special EU-China mechanism takes account of the positive influence on the politics of U S-China trade relations from the SED.

There are four motivations for an EU-China Dialogue mechanism. The first motivation, arguably the most central, is the demonstrable need to avoid EU-China policy sliding into a tit-for-tat protectionism. More moderately, it should avoid that increasingly hostile rhetoric on both sides (but primarily in Europe) prevents further market-access liberalization. There are considerable benefits to be gained from deepened commercial integration between Europe and China, but currently there is no adequate framework for moving bilateral relations further. Business-like market liberalization moves, oiling the negotiations for the wider commercial agreement within the PCA, and bilateral dispute consultation are the three other main drivers for such a forum for dialogue.

Damage limitation

As previously in the United States, there is in Europe today an increasing need for political mechanisms to calm passions and protectionist instincts. Put differently, there is a need for "damage control": to avoid that overt or covert measures damaging Europe's own economy are introduced. Rhetoric is sliding in China too, but so far not to the same degree. However, for China to continue its programme of market liberalization it will need new, post-WTO accession focal points to harness its policy.

"China bashing" used to be reserved to a handful of member states in Europe. Yet recently the European Commission itself has politicized Chinese commercial relations, rendering the need for the Dialogue even more pressing.

For many years, several European national leaders have been trading in hostile rhetoric towards China. They have usually been from the protectionist wing of the EU membership. Nicolas Sarkozy, the French President, excelled in China-bashing rhetoric in his election campaign, and he continued in the same vein as the newly elected president. In France, China became the antithesis of the "managed" and "regulated" globalization favoured by Gaullists and socialists alike. China, its entry into the world economy, and the globalization it has helped to shape were used as punch bags in the French election campaign. Many other countries in the protectionist wing of the EU have also treated China in a similar vein – as the "juggernaut" of the world economy.

The German Chancellor, Angela Merkel, has also stepped up the critique of China in a way that deviates from her habitually sober, unassuming, issue-based political rhetoric. German companies have been very successful in China – and German consumers have benefited a lot from growing imports – but the German politics of globalization remains patchy and uneven.[12] During the German EU and G-8 Presidencies in the first half of 2007, Chancellor Merkel took the initiative to launch a new mechanism to harmonize regulations in the EU and the United States. The merits of this initiative are compelling. Yet it was a telling symbol of her view of globalization that this new transatlantic process was partly motivated by the increased competitiveness of China. Apparently impressed by China's competitiveness, Chancellor Merkel, as many other political leaders, expressed a zero-sum-game view of globalization that essentially perceives the success of other countries as perilous to one's own.

These are only two examples, but they indicate how China and its entry into the world economy have grown to be perceived as one of the most salient policy challenges to Europe. There have also been recent changes in EU's internal troop formation that might have consequences for Europe's China policy. Previously there were odd statements from more protectionist-leaning leaders in Europe about the need of a tough approach to China. The Commission itself, which controls the execution of commercial policy, has remained unresponsive to such calls. It has defied protectionist demands and pointed to the great benefits that the EU reaps from its commercial dealings with China. Equally important, the Commission has so far received strong support from the European countries that often support freer trade.

This political balance has subtly changed. Recently it has been the Commission itself that has led Europe in the direction of tougher rhetoric and policy.

This shift occurred in the autumn of 2007. The EU's key policy document on China policy, from the autumn of 2006, still suggested friendly rhetoric, continued (and stepped-up) mutual market-access liberalization, and a disciplining of its own actions.[13] It identified real concerns in China's trade and regulatory policy, but silently acknowledged that a shrill, confrontational, U S-style approach would not help.[14] A year later Peter Mandelson made a u-turn and moved away from his traditionally free-trade spirited rhetoric.

After his "juggernaut" statement in advance of the October summit, Mandelson continued, in several speeches and statements, maintained his overt and covert threats against China. In the late autumn, during a visit to Beijing, Mandelson – together with José-Manuel Barroso, the President of the Commission, and other EU leaders, especially from the Eurozone group – unleashed European China bashing. The message was clear: China is manipulating its currency, at the expense of the EU. Unless it takes measures to lower its bilateral trade surplus with the EU, China will face punitive actions, such as an increased use of trade-defence instruments.

All this rhetoric might be just rhetoric. But the change in the Commission's position should not be neglected. It might also change the internal balance in the EU between the free-trade minded group and the protectionist-minded group. Previously the Commission itself safeguarded EU policy against "China-bashing" demands. Countries in favour of freer trade gave their strong backing as they knew they had the support of the Commission. Now this group has to pick fights with the Commission, which adds another layer of complexity to the policy-making process.

The EU's policy for trade remedies is at the centre of this change of balance. The anti-dumping case on air compressors, and the review of the EU's use of trade defence instruments that was recently shelved, illustrate the change in the internal troop formation. China has been at the centre of both issues.

The review was initiated by Peter Mandelson in the autumn of 2006, around the same time as the China strategy was launched. Set in the context of recent embarrassing anti-dumping and safeguards cases (Chinese textiles – the "Bra War" – and Chinese shoes), the intent of the review was to establish new, stricter routines and standards for EU antidumping policy. In early 2007, Barroso pulled the plug of this review, allegedly on the grounds of not provoking anti-EU opinions at a time of ratifications of the Lisbon Treaty. Yet another reason for not moving forward the reform of EU anti-dumping policy, often heard on the Brussels grapevine, was the forthcoming negotiations with China. Rather than giving away one of the negotiation cards in advance, Europe would sit on it for a while to exchange concessions from China.

The details of the air-compressor case reveal the changing political dynamics. An EU investigation pointed to the alleged presence of dumping and established causation of material injury to domestic industries. However, after assessing the effects on the entire community by the introduction of an anti-dumping tariff, the responsible entity in the Commission could *not* recommend a punitive tariff. This recommendation was put to the member states, and a consultative voting by them gave support to this recommendation.[15] Then the issue was transferred to the Commission College for a decision: the latter took the opposite view. Three Commissioners in particular objected to this recommendation, especially to the use of the so-called community interest clause. Hence, the Commission decided, against the will of the member states, to introduce an anti-dumping tariff.

One can dispute the substantive merits in favour or against anti-dumping tariffs on air compressors. Yet this case exemplifies some interesting features of relevance to EU-China relations. On previous occasions when individual anti-dumping cases became politicized, the process was driven essentially by member states calling for the Commission to take a more anti-dumping friendly view. The air-compressor business reversed the case. This will affect the standard defence by the Commission – "Don't blame us, blame the member states!" – in politicized cases where serious questions are being raised about the merits of antidumping.

Such a drift away from traditional policies within the Commission leads us to the chief motivation for a Sino-European dialogue mechanism. To prevent EU policy, and rhetoric, against China from becoming more confrontational, the Commission needs to be tied to a political process that establishes greater awareness of the costs of its own actions. As with the U S Congress, the Commission needs greater awareness of the opportunity costs of "being tough" against China.

However, it is not only the Commission that needs to be tied to such an agenda. The Chinese government needs it too. Furthermore, individual member states in the EU that have for a long time been on the protectionist side, or member states that recently moved in that direction, also need to be confronted with an agenda that presents the opportunity costs of policy alternatives with greater clarity. This is lacking in the current discussion in Europe. Some of the voices calling for tougher action against China assume that Europe does not have to pay anything if measures are taken.

Market-access liberalization

The second motivation for an EU-China dialogue takes account of the potential market access that can follow from reciprocal bargains and from actions by China to open its markets further and make more efforts to enforce WTO obligations.

A Free Trade Agreement between Europe and China has already been refuted by the EU. Even if the idea has received silent endorsement in the higher echelons of Chinese trade policy, the Global Europe strategy paper of the EU explicitly rules out such an FTA.[16] This is a correct strategy, at least for the time being. If an EU-China FTA is to be commercially serious it would require a political backing in Europe that simply is not there. Furthermore, it would require reforms in Europe and in China that now seem alien to both.

However, concrete, reciprocal market openings, and co-operative measures, can be achieved without an FTA framework. Both parties have requests for the other side (see Annex), and some of them can be accommodated in a low-key manner by concrete, small-scale, business-like negotiations. Such improvements could deepen integration further and can, if done in a way similar to the U S-Sino dialogue, can, if done in a way similar to the US-Chinese dialogue, help to bring down the tensions in Europe.

Oiling the commercial negotiations

The third motivation is institutional in its nature. The EU and China will soon start negotiations to upgrade their commercial agreement from 1985. These negotiations will be undertaken within a larger process of negotiating a Partnership and Cooperation Agreement, and will therefore involve many non-commercial areas and objectives.

The commercial agreement will be negotiated separately from the PCA. However, there will be mutual spillovers between the broader PCA negotiations and the commercial discussions. It will be impossible to keep them entirely separated. The influences from the PCA can be positive and facilitate smooth commercial negotiations. Yet it is more likely that it will be the other way round. The PCA process will address no-less important but highly contentious issues such as climate change and human rights. The issue of Tibet's independence from Beijing will for sure be part of the PCA discussions. If commercial issues are negotiated in the same context as the PCA, there is a clear risk that negotiations on most topics will end up grinding to a halt.

A Trade and Economic Dialogue between EU and China can oil the commercial negotiations by giving them a strategic medium-to-long-term context and some building blocks of concrete, small-scale, low-key achievements. The U S SED has shown that such outcomes are possible, while broader policy shifts that both Europe and the U S are interested in can be pressed for only on a medium-term horizon.

Bilateral dispute consultation

China is now likely to be challenged more often by the EU in the WTO dispute settlement mechanism. Hitherto there have hardly been any legal disputes between the EU and China. Indeed, the EU leans more towards the diplomatic rather than the legalistic tradition of dispute settlement, and has therefore often shunned taking matters to the WTO. China also tends to prefer to settle disputes bilaterally by amending its policy rather than by being challenged in a legal structure. These approaches are also explained by the influence of popular views that tend to believe that a dispute in the WTO equals a trade war.

However, these strategies are evolving. The number of EU challenges against China will increase. The EU was recently part of the group of countries (together with the United States and Canada) challenging China for its tariff structure and tariff increases on automobile parts. Also the EU and the United States have recently started a WTO process concerning financial information services in China. China, for its part, also seems to be altering its strategy as well. It clearly favoured a full WTO dispute-settlement process "to the bitter end" in the automobile-parts case, although knowing it was likely to be the defeated. Its previous strategy to solve matters diplomatically did not apply in this case. Comments by the Chinese government to the new case on financial-information services signal a similar strategy.

Greater use of the WTO dispute settlement mechanism can even be a sign of strength in bilateral relations: it shows that matters are being solved in a structured, legal manner, insulated from an in other respects good bilateral commercial relationship. Yet there is an institutional logic pointing to consultation and diplomatic resolve: the first step in every case of WTO dispute settlement is consultation and bilateral discussions. The intent of this first step is clearly to get the two parties to amicably settle the matter without the establishment of a WTO panel that would lead to a legal ruling. It is also beneficial to the countries involved if matters are solved bilaterally in diplomatic discussions.

If disputes are discussed in an EU-China Dialogue, there is of course the danger that a complaining party might have to trade other concessions in exchange for the challenged party bringing its policy into compliance with its WTO obligations. Yet there are reasons that speak for closer bilateral consultations between the EU and China, including efforts to settle disputes bilaterally.

The first reason is to avoid that dispute settlement becomes politicized and used on other grounds rather than as a means to solve a concrete commercial problem, where one party claims that the other party has distinctly violated WTO rules. There are several practices in China that the EU thinks a WTO panel would rule against if Brussels "took China to court", but where actual change in China, because of the ruling, is unlikely. Furthermore, a WTO ruling can also be the green light needed for erection of domestic barriers against another country. That runs against the chief idea underlying the multilateral trading system and only raises the welfare cost of measures that were ruled against.

The second reason is that if the dialogue really develops in a friendly manner that inspires effective, business-like, problem-solving attitudes, many of the areas that the EU is concerned about will be solved without a long, uncertain legal process. It saves time and resources.

4. CHALLENGES TO AN EFFECTIVE EU-CHINA DIALOGUE

There are many reasons for setting up a new mechanism for bilateral discussion and negotiations between Europe and China. However, this Dialogue cannot work in the same way as the U S-China Dialogue. There are two main reasons why the Dialogue could prove ineffective from the start: if the process does not address institutional constraints, especially on the European side, and if the agenda is not properly designed.

Institutional setting

Four main areas need to be addressed in order to set up a working EU-China Dialogue on economic and trade matters: European trade and investment negotiation tools; getting the Commission's mandate right; adequately involving the member states; and leadership issues.

- EU trade and investment tools

The EU trade-policy body is in many ways focused on typical trade negotiations dealing with policy issues. Policy negotiations should also make up the core part of the EU-China negotiation agenda, but they are unlikely to be the only aspect of the negotiations. Many of the issues covered in the U S-China SED should be folded under the "promotion" or "facilitation" heading rather than in the policy column. Negotiations are not only about market-access reforms, but also about making actual trade happen: doing the deals. The differences are sometimes subtle, but it is definitely one preferred way of the Chinese to deal with bilateral negotiations. They can grant access for a stock exchange to set up operations, but to change the entire policy for financial market places is another matter altogether.

This is not a structure that the EU easily can agree to or deal with. The EU has centralized its trade policy, but the Commission is not responsible for promotion. All member countries, though, have export promotion and investment-facilitating governmental or semi-governmental bodies. What is more, the Commission has no experience of deal-making: its staff is made of negotiators, not salesmen. Nor are there ways for the EU to change this. Indeed, there are even good reasons *not* to. But for the negotiations to be effective, the EU will have to consider how to address China's offers of concrete business deals and how to gauge them in policy measures. China will also have to be aware of the limits of the Commission and its strong focus on policy.

- EU mandate

The European side in this Dialogue will be headed by the European Commission, but it will have to seek a mandate from its member states. This mandate might (and probably will) have to go beyond what currently falls under EU jurisdictional competence. In fact, it will have to extend beyond current boundaries if the EU wants to get from China what the U S has already been granted, and is asked to reciprocate.

Financial services in particular will reveal the fundamental dilemmas. The EU has competitive advantages in financial services, and the U S has recently been granted new market access that EU financial firms equally want to enjoy. But the EU does not have a strong and centralized policy for financial services, and in the current structure the EU might not be able to offer *to* China the very same deal that it wants *from* it.

The obvious solution is to seek a mandate from the member states that goes beyond the current jurisdictional competence. That is possible. But is it *feasible*? If it is feasible in the internal European process, will China accept to go through the subsequently cumbersome process? Inevitably China will have to sign deals with 27 member states as relevant regulations still fall under national competencies. China might not be willing to do that. In return, China might also request assurances for its own investments in Europe, and that is an area where there are considerable differences between EU member states, in applied policy as well as in ambitions concerning changes in market structures and regulations. The EU might not be able to deliver to the Chinese on the ground level what it might offer at the negotiating level.

There are also issues of the taxonomy and level of detail of the EU mandate. In other commercial negotiations, the EU Council normally grants a mandate to the Commission. Such mandates are rarely detailed. This is a necessity in multilateral negotiations, to a lesser extent also in bilateral negotiations over Free Trade Agreements. But now the EU is about to seek negotiations that are smaller in scope but yet more hands on. This might (and probably will) require a mandate that goes considerably more into details – in particular if the EU aims at negotiations on issues outside the EU's jurisdictional competence.

Furthermore, the EU might (and probably will) have to seek a mandate that covers all the envisioned negotiation areas. That would be in contrast to the U S-China SED, in which the agenda has evolved and changed every six months. That might (and probably will) not be a feasible way for the EU. If it has to request a mandate for each meeting, there is a risk that the political process in the EU will not take account of the entire outcome but only look to the immediate issues for one particular meeting. EU countries might then start to ask for concessions China cannot possibly agree to within a specific area without possible gains from other areas being accounted for. Yet if the EU applies for a mandate to cover the entire Dialogue agenda, it might (and probably will) be too abstract and too inflexible, not taking account of neither the required level of detail, nor the likelihood of an evolving agenda that encroaches upon national competencies.

- EU member state participation

Considering the disintegrated structure of EU commercial policy, the Commission will have to consider how to engage member states in the dialogue. If Europe wants China to open markets of strategic interest, it probably will have to grant China equal access. The overriding concern of the Commission will be to find ways for the EU to grant similar access to Chinese entities without having to go through a cumbersome internal process.

However, this is only one part of the dilemma. EU member states also have individual ambitions in their dealings with China. In the first place member-state governments want to sell goods and services from their own country, and China offers a huge market with increasing purchasing power. If that promotion agenda is not being addressed in the dialogue negotiations, member states will have to seek other ways to negotiate with the Chinese. Yet a parallel track of trade promotion, that might involve negotiations with the government, can disturb the Dialogue process. Bilateral negotiations with EU member states can be marginally more profitable than turgid negotiations with a policy body not able to strike the sort of deals China prefers.

In the second place, many EU countries have policy ambitions in their relation to China that go beyond an agenda entirely based on areas of centralized policy in the EU. In 2005 Germany finished a new Bilateral Investment Treaty with China. France and the United Kingdom have old BITs with China that need to be updated. Other countries have similar demands. Again, if bilateral negotiations of an individual member state of the EU with China occur simultaneously with the Dialogue negotiations, the latter can be damaged.

- Who shall lead?

One key lesson from the U S-China SED, and from all the working parties between EU and China, is that strong political backing from the top political level is required if the agenda is to work properly. For Europe it is difficult to guarantee such a backing. Especially: who would give the backing?

The Commission is the responsible body for EU commercial policy, but it is not a strong entity equivalent to a national government. Its hands are often tied by member states. Furthermore, the responsible Commissioner for external policy has recently been curtailed by his colleagues. His views were neglected in one of China's key areas in its dealings with Europe: the anti-dumping review. The recent handling of the air-compressor case has also raised questions as to the scope of his authority.

The Commission president is keen on an EU-China Dialogue, but it remains uncertain if he himself commands the sort of authority needed to address the issues that inevitably will be at the centre of the dialogue. Furthermore, Barroso, as well as the rest of the Commission, do not know if they will stay in Brussels after the expected change of guards in the early autumn of 2009. The political game in the design of the next Commission has already started and will increase in intensity the closer we get to the appointment of the new team.

These institutional and political problems are not insurmountable. But they reveal the need to establish an institutional structure that promotes a longer view, thus enabling negotiations to continue intact after the current Commission leaves. Stronger-than-usual involvement by member states will be required as well. Finally, outside the political process: establishing a strong EU-China business council might be another way to ensure continuity.

Agenda design

Many of the challenges mentioned above require an agenda tailored properly and in accordance with the institutional and political constraints of both parties. Three aspects should be kept in mind.

Firstly, the negotiation agenda has to be based on reciprocal bargains. Europe has greater demands on China and can justifiably call for more action by the other side, but it must be prepared to grant China improvements on its key demands. If that is not really understood by the EU – and there are reasons to believe it is not – it is of no use to start the negotiations. They will simply end up nowhere.

Secondly, the focus should be on deliverables in the fields that cause contention in EU-China trade politics. These areas are not difficult to observe. The EU wants concrete results in enforcement of intellectual property rights, in greater disciplines on subsidies, and in better market access for key services. China, on the other hand, wants market-economy status, greater disciplines on the use of antidumping, and better assurances to avoid non-discriminatory measures for its companies and sovereign wealth funds investing in Europe.

Thirdly, the two parties must avoid initiating new policies that are obviously contradictory to the spirit of the Dialogue and to increasing integration between them. One such issue concerns carbon tariffs against countries that have not signed an international agreement to reduce carbon emissions. If such policies are seriously suggested, let alone implemented, by the EU, the obituary of this Dialogue can be written.

6. POLICY RECOMMENDATIONS

- The Dialogue should start with a clear intent and agenda. It is better to postpone the launch of the agenda beyond the current target date in late April if there are uncertainties about the agenda and what the parties can deliver.

- The design of the agenda should directly address the key issues that currently cause frictions in EU-China bilateral trade politics.

- The agenda should focus on what is feasible. The EU and China need to show restraint in their demands from the other party. They should only call for what is jurisdictionally and politically possible to achieve.

- To enable a structured dialogue focused on proper targets, EU and China should set up a joint study group to screen the substantive matters at hand and to suggest methods to surmount jurisdictional dilemmas. The launch of the EU-India FTA negotiations was helped by the EU-India High Level Trade Group, which outlined the key areas for negotiations and instituted a level of ambition that political leaders later followed.

- The Commission should consider ways to involve key member states in the negotiations. This might be necessary to avoid distractions of the dialogue negotiations and to enable a strong focus on the negotiations that can yield the greatest outcome.

- European and Chinese firms with strong interests in each others' markets should set up – outside the present business associations – a Council similar to the U S-China Business Council, which keeps track of the dialogue and the other commercial negotiations. Involvement from such bodies can give the political support needed to take politically uncomfortable decisions.

ANNEX

TABLE 1. EU-CHINA COMMERCIAL-POLICY AGENDA AND RESPECTIVE COMPETENCES WITHIN THE EU			
WHAT EUROPE WANTS FROM CHINA	**RESPECTIVE NEGOTIATING COMPETENCIES WITHIN EU**	**WHAT CHINA WANTS FROM EUROPE**	**RESPECTIVE NEGOTIATING COMPETENCIES WITHIN EU**
ANTIDUMPING AND SAFEGUARDS			
		Recognition of Market Economy Status.	Commission
		Antidumping and safeguard measures *Stronger EU disciplines.*	Commission
TARIFFS			
Tariffs *Removal of peak tariffs in textiles and clothing, leather and fur, footwear, ceramics, steel and vehicles.*	Commission	**Tariffs** *Removal of peak tariffs on garments, leather goods and other manufactured exports.*	Commission
		Agricultural tariffs *Lowering of tariffs for certain agricultural produce.*	Commission
INVESTMENT AND INNOVATION			
Intellectual property *Better enforcement and an end to forced technology transfers.*	Split Commission / member states.		
Foreign investment restrictions in manufacturing and services, *e g joint ventures instead of full ownership. Special EU concerns: telecoms and financial services.*	Overwhelmingly a member state competency (e g bilateral investment treaties).		
Subsidies *EU wants stronger disciplines.*	Commission		
		Chinese investments *More openness on Chinese M&A, FDI and sovereign wealth funds.*	Member states
NON-TARIFF BARRIERS			
Non-tariff barriers *Product certification, labelling standards, import approval requirements, customs clearance.*	Commission	**Sanitary and Phytosanitary (SPS) rules, Technical Barriers to Trade (TBT).** *Render EU measures less trade restrictive.*	Commission
RULES AND REGULATIONS			
Government procurement. *EU wants China to accede to WTO Government Procurement Agreement.*	Commission		
Competition *Strengthening of rules.*	Commission		
Trade Facilitation	Commission		
OTHER			
		Agricultural subsidies *Reduction of EU subsidies.*	Commission
Exchange rate	*Concerns the Eurogroup and ECB only.*		

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FOOTNOTES

1. In order to address issues related to the exchange-rate policy and macroeconomic stability, a separate Working Group between the European Central Bank and the People's Bank of China was set up at the same EU-China Summit in December, 2007.

2. In 2008 ECIPE will publish several papers on EU-China trade relations which will examine the substance and policies of EU-China economic integration.

3. But this discrepancy has much more to do with the replacement of exports to Europe from other Asian countries to China. Simple data on bilateral trade growth do not reveal what actually has happened in EU-Asia trade integration in the last ten years. Furthermore, a soaring bilateral trade deficit with China cannot, alone, be considered material evidence for an unbalanced trade relation.

4. OECD (2007).

5. European Commission (2007).

6. There is also a Strategic Dialogue between China and Japan. Set up in 2005, this Dialogue has a much broader agenda and only partially covers commercial issues.

7. Ikenson (2007).

8. U S Government info.

9. The exact tariff of 27.5 percent was determined by the estimated levels of Yuan undervaluation: 15-40 percent (27.5 is the midpoint between 15 and 40).

10. Hufbauer et al (2006).

11. Mandelson (2006).

12. Erixon & Freytag (2007).

13. European Commission (2006a).

14. See Peter Mandelson's press comments when the China strategy was launched.

15. The support, however, was weak. The result of the voting was 13 in favour and 13 against the recommendation. One country abstained. According to voting rules, abstentions should be counted in favour of the opinion of the Commission.

16. According to European Commission (2006b), p 11, China "requires special attention because of the opportunities and risks it presents."

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Phone +32 (0)2 289 1350 Fax +32 (0)2 289 1359 info@ecipe.org Rue Belliard 4-6, 1040 Brussels, Belgium