

### China, the European Union and the United States of America: partners or competitors?

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**China, the European Union and the  
United States of America:  
Partners or Competitors?**

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***Abstract/Zusammenfassung:***

This working paper brings together assessments of the trilateral relations between China, the EU and the US from the disciplines of political science and economics.

The first paper primarily addresses the following three issues: a) China's current development and prospects b) EU-China relations, and c) recommendations in terms of EU policies towards China.

The second paper applies a three tier analysis looking first at changes in the Chinese and global economic setting caused by China's WTO accession.

It then takes a look at the bilateral economic relations between China and the EU and US respectively. Finally the scored goals and competing interests of the USA and the EU vis-à-vis China are analysed.

*Keywords/Schlagwörter:* EU-US-China relations, China's domestic development, EU policies, China's external economic relations, China's WTO accession, structural change, World economy

*Procurement/Bezug:*

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**by Thomas Heberer**

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**by Markus Taube**

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# **China's Domestic Development, China-EU relationship, and EU-China Policies**

**(some preliminary hypotheses)**

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## **1. Introduction**

My contribution primarily addresses the following three issues:

- a) China's current development and prospects
- b) EU-China relations, and
- c) recommendations in terms of EU policies towards China.

As far as China is concerned, the organizers suggested that I should focus on China's domestic issues and developments and on EU-China policies.

Let me start by quoting a comment of one of the largest German regional newspapers the "Westdeutsche Allgemeine" during Jiang Zemin's visit to Germany in April of this year that is an expression in which manner China is perceived by the German media:

"China's state and party leader Jiang Zemin is endowed with all preconditions of an untipathetic person. He and his functionary clique rule an entire people of more than one billion in a despotic way. Disliked political opponents are thrown into prison or tortured, ethnic and religious minorities are persecuted, and every year hundreds of people are executed after dubious court proceedings. China is a dictatorship, and Jiang Zermin is a dictator. There is nothing to be palliated."  
(Westdeutsche Allgemeine 9 April 2002)

Everybody who is acquainted with the situation in China knows that this is an one-sided picture that does not entirely reflect the reality of China's current situation. Yet, such statements have an impact on the matter how Germans perceive China to be.

In contrast, I will draw a somewhat different picture.

## **2. Domestic Development**

1. I argue that China's current domestic development is characterized by the following six features:

- Rapid social change (urbanization, modernization of institutions, emerging of new elites, social differentiation and stratification, migration, spatial mobility, etc.)
- Economic bottom-up privatization (spontaneous process of privatization from below in terms of self-employment, founding of enterprises by individual people)
- Economization of the bureaucracy and of politics (economic activities and performance as pivot of all activities; income and promoting of cadres were linked to economic performance; transfer of cadres into economic domains, etc.)
- Change of individuals' and groups' attitudes and behavior vis-à-vis the state/the Party (critical assessment of Party and state performances; increasing consciousness of legal rights; etc.)
- Alteration of ideological parameters ("Three representatives"; replacement of "class" by 'strata'; 'patriotism' instead of Marxism-Leninism; acceptance that private entrepreneurs may join the Party)
- Incremental change of political structures, particularly in terms of participation (rural and urban elections, social associations, function of local People's Congresses, etc., see below).

Meanwhile, China's system can be classified as a system of *fragmented authoritarianism*, i.e. the coexistence of different socio-economic patterns and a pluralization of society.

2. Yet we should acknowledge that despite of all economic successes and of social change China is still a developing country in transition from a planned to a market economy, facing all the problems and tensions emerging from such a step.
3. The original patterns of the *Four modernizations*, that could be classified as a *modernization without modernity*, are increasingly replaced by a system of six patterns of modernization:
  - Modernization of economy (including that of science and technology)
  - Modernization of military
  - Modernization of ideology<sup>1</sup>
  - Modernization of political and administrative structures
  - Modernization of intellectual thinking
  - Modernization of the legal system
4. Besides economic and social changes we find a set of features that can be discerned as a change of political structures and thus as a part of a political reform programme:
  - introduction of elections on village and urban inhabitants level;
  - the establishing of a law system has increased the popular awareness of rights and the desire of further legal protection;
  - new laws in the political sphere, for instance the Administration Litigation Law that permits to bring suit against government;
  - more free-space for the People's Congresses (for instance to express dissatisfaction by means of voting, permitting of revisions of laws and documents put forward by the government, presenting petitions, etc.);
  - the framework for a civil service system was laid;
  - the existence of various associations in the social sphere was permitted;
  - access to the Party by new strata (for instance private entrepreneurs);
  - shift from a Marxist-Leninist ideology towards a more integrational, national ideology and thus a shift from a Communist Party towards a "party of the entire people" (Volkspartei);
  - larger freedom for intellectual debate in so far as the leadership of the Party is, at least verbally, accepted;

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<sup>1</sup> Refers to primacy of economics, discussion on 'Third way', primacy of professional knowledge, entrepreneurs' access to the Party, etc.

to mention only a few.

5. Yet the modernization process shows mixed prospects and faces major constraints characterized by five features of instability:

- Erosion of social entities (like village communities, danwei system, families)
- Increasing social insecurity
- Rising unemployment
- Growing regional and income disparities (for instance worsening of GINI coefficient)
- Corruption and arbitrariness of Party officials.

Grievances of workers and peasants are growing due to the restructuring of state enterprises (resulting in social unrests among workers) and the deterioration of the income of peasants. Prime minister Zhu Rongji in March called the latter his "biggest headache". At least in the short-run the situation might be worsened by WTO entry.

6. One feature of the Chinese developmental process in the last two decades was the societal activities vis-à-vis the state. My own reading is that the process of economic and social change was not initiated by an enlightened Party leadership, but rather by means of the collective action of various social groups. Such a perspective counterbalances the argument of an omnipotent power of the Party. Yet, undoubtedly, the political leadership has by and large supported those activities after discerning that they proved to be supportive in improving the system and thus the legitimization of the power of the CCP.

7. In contrast to previous periods the Party and its leadership today is no longer considered to be an "always correct and wise" institution. It requires its legitimacy by means of performance, i.e. by pursuing the following two primary goals:

- a) successfully enforcing important national goals (growth, development, and stability in domestic affairs; strength and successes in foreign policy and international issues);



- b) improvement of the living standard of the majority of the population without major upheavals. In the case that the Party leadership fails to achieve these goals various social forces could search for alternative political options.

Political scientist Xiang Lanxin is right in arguing that, indeed, there exists a legitimacy crisis but not due to a failure of development, but rather due to its success.<sup>2</sup>

8. As far as the group of leading officials is concerned, we can discern a gradual change from *Party bureaucrats* that rose to power by means of inner-party advancement towards an *industrializational elite* with an academic background. Meanwhile, the members of the latter constitute more than half of the members of the Central Committee. They might be more open-minded towards innovation and social change than Party bureaucrats, particularly as such people prefer economic goals to political ones. Therefore more principle changes could be expected in the near future.

9. China differs from a majority of developing countries as it has, undoubtedly, a **strong state**. An important attribute of a strong state is **state capacity**. I argue that China has the capacity necessary to enforce its policies. State capacity encompasses the following features:

- **Legitimacy** in the sense of the legitimation of the political system accepted by its citizens;
- **regulating and controlling capacity** in the sense of social control and regulation;
- **resources for enforcement** (financial and coercive means as well as personnel resources);
- **bargaining capacity** i.e. the ability to incorporate new social groups, associations and organizations into bargaining processes and to find a balance between various particularistic interests; and last but not least
- **learning capacity** i.e. the ability to learn from mistakes and failures.

The latter is particularly important as it is a necessary precondition for further development. It implies that the state draws conclusions out of past mistakes and failures that will result in different or improved policies. Learning in this sense means to search and find new solutions for problems. In this very sense state capacity currently is more than power of enforcement.

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<sup>2</sup> Lanxin Xiang 2001, p. 13.

10. State capacity, too, finds its expression in the fact of development. By that I do not mean merely economic growth, but the combination of economic growth and development. By development I mean what some scholars in developmental theory call a "magic pentagon" i.e. the five elements

- **Growth** (economic growth plus reduction of poverty, improving of the living conditions of the majority of the populace and efforts to reduce environmental degradation)
- **Employment** (employment-oriented development, for instance fostering self-employment as well as employment in the private sector)
- **Equality and justice** (including social policies and social security, gender equality and women's empowerment, etc.)
- **Participation** (in social and, partially, also in political affairs)
- **National independence** (low debt ratio, high rate of foreign exchange reserves).

In tendency, I argue, China is progressing along this path.

11. Yet, China's further development depends on several factors as for instance:

- Whether or not the political leadership succeeds to curb with the above-mentioned potential of social crises and thus succeeds to guarantee social and political stability
- Whether or not the leadership will be able to initiate a careful process of substantial political reforms
- the international environment and China's foreign policy (for instance in terms of the Taiwan issue).

### **3. EU - China Relationship**

12. European China policies have to take into consideration that

- as far as national interests and international relations are concerned, China perceives the US to be more important than the EU. This is particularly true as the EU countries speak with different voices and are not perceived by China as an united and strong political

entity. China turns to Europe primarily in the case that relations with the US become problematic. Thus the EU appears to be a counterweight to the US.

- Similarly, the relations with the US and Eastern Europe seem to be more important for the EU than the relationship with China. Yet, for the EU China seems to be the most important country in Asia, economically as well as politically.
- China as a market is far more important for the EU countries than human rights issues. Sensitive issues are rather left to US policies. Yet, a division of labor between the US and the EU, for instance in terms of human rights issues, whereas the US puts a stronger pressure on China while the EU rather pursues a dialogue might complement each other. Thus the question arises whether cooperation and coordination between the EU and the US China policies are really necessary. A close cooperation might, in fact, give China the expression to be pushed in the background and therefore might turn out to be counterproductive.

13. In contrast to the US the EU at present apparently pursues a more diplomatic, discrete and different political style in approaching China (dialogue instead of confrontation). Furthermore, EU policy papers argue more in a way that despite of different political systems there are a lot of common grounds and points of common or similar interests between the EU countries and China. Indeed, no major conflicts between both sides exist, if we understand by conflict a situation of competition within which actors are conscious of the incompatibility of their positions and within which each actor has the desire to take over the position incompatible with the desire of the other party. Furthermore, EU policy papers perceive China as a country that moves in a positive direction and has the intention to become a reliable partner and a "civilized" political system. This "move" is considered to be stronger in domestic policies than in issues related to national or territorial problems like Taiwan or Tibet. Undoubtedly, it is necessary to differ between China's various interest domains in order to draw a more precise picture of its standpoint and its development processes.

14. Taking into consideration the common interests and perspectives of both parties the EU intends to support the Chinese development processes in economic, social and political terms (support of economic reforms, political liberalization and social pluralization) in order to enhance China's capacity of governance and sustainable development.

15. According to various EU common statements (for instance "Towards a New Asia Strategy" of 1994, "Long-Term Policy for China-Europe Relations" of 1995 or "Europe and Asia: A Strategic Framework for Enhanced Partnership" of 2001) the predominant interests of Europe in Asia as well as in China are in the domains of economics and politics (Wim Stokhof from Leiden called it "money and influence"). The EU wants primarily "to strengthen its economic presence in Asia in order to maintain its leading role in the world economy". Certainly such an intention apparently can not easily be combined with human rights issues. Yet, other statements as "Building a Comprehensive Partnership with China" (1998), the respective Report on its Implementation (2000), the "China Strategy Paper" (2002) or the "National Indicative Programme 2002-2004 China"<sup>3</sup> are more principally concerned with political issues and issues of human rights.

#### 4. Recommendations

16. The European Community is well aware of the ambiguity of China's development: on the one side a process of rapid economic development, social change and pluralization, on the other side a challenging and enormous potential of instability. Albeit a common strategy and common policies of the EU vis-à-vis China do not yet exist, the European countries should, in future, cooperate with China in the following domains:

- In the sphere of **developmental cooperation**: (1) improvement of living conditions and of social justice, maintaining/restoration of the natural basis of life; examples for that are: poverty reduction, improvement of environment and food security, empowerment of women; (2) employment and social security issues: for instance establishing/improving social security systems in urban and rural areas, promoting self-employment in the small-scale sector; restructuring of the rural financial system (credit cooperatives, particularly for self-employed people and for women);
- In the sphere of **participation/civil society**: supporting of rural and urban elections and the establishing of social and interest associations (for instance non-profit organizations NPOs, and NGOs) in various spheres;
- In the sphere of **legal system**: support to establish a law system and legal thinking; promotion of civil forms of conflict handling;

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<sup>3</sup> Cf. China aktuell, March 2002, pp. 282ff.

- In the sphere of **human rights**: Though it might be questionable whether or not dialogue in recent years between EU and China in terms of human and other rights proved to be successful, dialogue might still be preferable to pressure. The latter might not be of much help, particularly as the EU countries do not pursue a homogeneous policy in this respect; hence China does not fear any pressure by EU countries. Yet, by no means should a dialogue prevent the EU to criticize China's deviations from internationally accepted standards.

17. The above mentioned "National Indicative Programme" of the EU shows that the Union is proceeding along this path. This programme discerns three domains of priority for EU-China cooperation:

- a) Support of the social and economic reform process (development of human resources; support of the transition to a market economy that include the strengthening of administrative capacities in order to ensure compliance with WTO requirements; support of minimizing social consequences of the reform);
- b) Environment and sustainable development (for instance environmental programmes, biodiversity protection, water resources conservation);
- c) Good governance and the strengthening of the rule of law (including fight against illegal migration, support of civil society).

18. But dialogue and cooperation between states alone are not sufficient. To support and enhance the dialogues between societal organizations (NPOs, NGOs, and GINGOS, governmental organized NGOs) in terms of issues of social justice (poverty reduction, enlarging participation, environment protection, etc.) is necessary. This should include dialogues on issues as human rights, good governance and minorities policies.

19. In terms of EU-China exchange the EU countries should support that

- China will become an (associate) member of the G-8 countries
- Chinese social associations gain the opportunity to participate actively in the Asia Europe Peoples Forum of NGOs which accompanies the ASEM dialogue between Europe and Asia. A similar institution for exchange between Chinese and European NGOs should be established and supported by the EU.

- More important, the European dialogue with China increasingly should include non-state domains (for instance social associations, NPOs, GINGOS, NGOs, etc.). This might help Chinese NGOs to join trisectoral or global public-policy networks thus enhancing their knowledge and policy capacity.

By means of the following diagram I argue that the crucial issue for China is economic, social and political stability. If the political leadership succeeds to sustain stability we could expect a development in terms of further political pluralism, rule of law and privatization. Then, a minimal state might occur that confines itself to the shaping of the economic, social and political macro-framework. If the leadership will fail political repression, increased state's intervention and command economy with a maximal state and stronger authoritarianism could be the outcome. Concurrently, the positive scenario would foster „patriotism“, a kind of developmental nationalism primarily aiming at inner integration and mobilization for modernization. In contrast, the more negative scenario could produce a more aggressive nationalism as a compensational ideology that could turn against other countries.

# China's Development Options

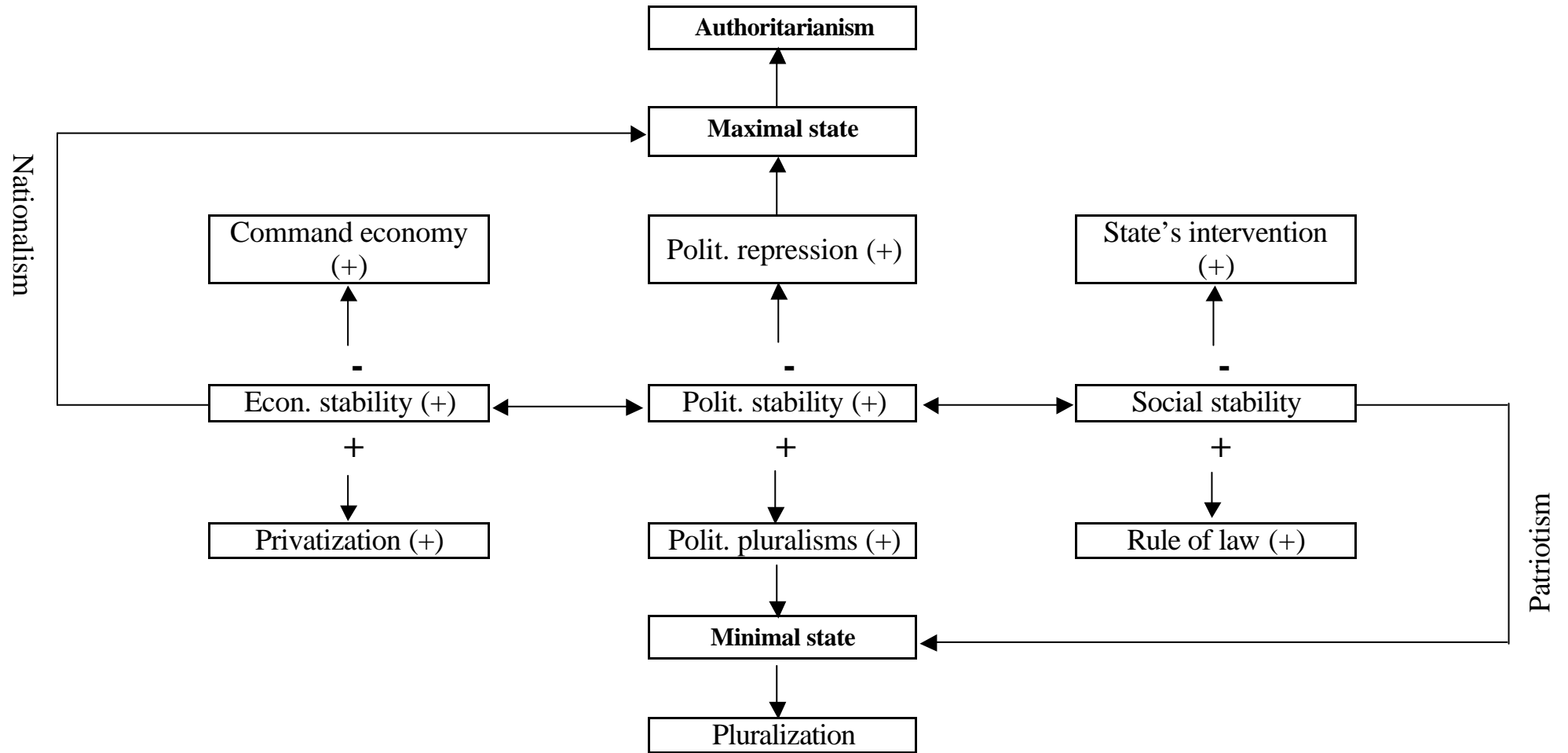


Schaubild: Heberer

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# **Transatlantic Economic Competition and Cooperation with China in the post WTO Accession Era**

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## **1. Introduction**

On December 11th 2001 China has finally become a full member of the World Trade Organization (WTO). This event marks the end of China's "long march" into the WTO and represents at the same time a logical step in its market transformation process. China's WTO entry is de facto a policy agenda for economic liberalization and signals to economic actors inside China as well as in the world market that China's transition to a full fledged market economy will continue and not stop in the middle of the road. As such China's membership in WTO is nothing more or less than a - credible - commitment to create and sustain a market oriented economic regime based on the principles of non-discrimination and transparency. It constitutes the (formal) completion of a total turn about-face from China's former strategy of self-sustenance to one of full participation in the world economy.

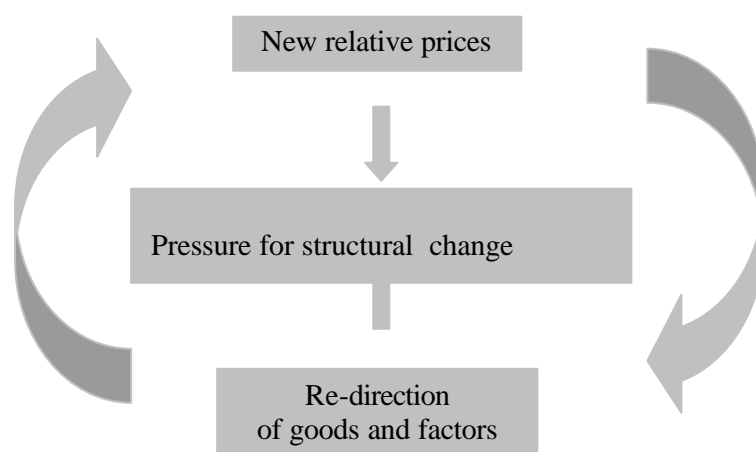
While bringing about some very profound changes in the economic setting Chinese economic actors are facing, the Chinese WTO accession will at the same time lead to some changes in the world economy as alterations in relative prices will induce a re-orientation of global flows in goods and factors. On top of that, the geo-political arena will experience some re-structuring as the constellation of interests of the various actors will undergo some changes.

This paper will focus on one particular aspect of the multitudinous implications China's WTO accession will have on the global setting, i.e. the trilateral relationship between China, the US and the EU. In order to do so a three tier analysis is applied. In a first step we will have a look at what changes there will be caused by the Chinese WTO accession. On the basis of these findings we will then have a look at China's bilateral economic relations with the US and the EU. Finally we move on to analyze the shared goals and competing interests of the USA and the EU vis-à-vis China and try to evaluate the potential for transatlantic cooperation and competition.

## 2. Changes of the Global Economic Setting Induced by China's WTO Accession

The liberalization program "WTO accession" will change the Chinese economy but also induce modifications in the structure of the global economy (Kye 2001, Ma / Wang 2001). The driving force behind all these developments will be changing relative prices which enforce structural change. The exploration of new fields of economic interaction, which until then had been beyond the reach of economic actors because of administratively erected barriers to trade, will alter the direction, composition and volumes of international good flows and induce a reallocation of production capacities (factors of production) as well. These processes will be the cause as well as the result of a modification of relative prices (see chart 1).

**Chart 1: The driving forces of change**



A simple model<sup>4</sup> illustrating these mechanisms on the product level is presented in chart 2. The dotted lines in chart 2 depict the iso revenue lines of a Chinese enterprise before the WTO entry. These iso revenue lines show alternative combinations of the goods x and y which create the same revenues for the enterprise. The higher a line lies in the chart the higher the revenues. The uninterrupted lines depict the iso revenue lines of the enterprise after the WTO entry and the corresponding price shock. The concave curve, finally, represents the production possibility curve, i.e. the various modes of production the enterprise may choose from with given factor inputs and production costs.

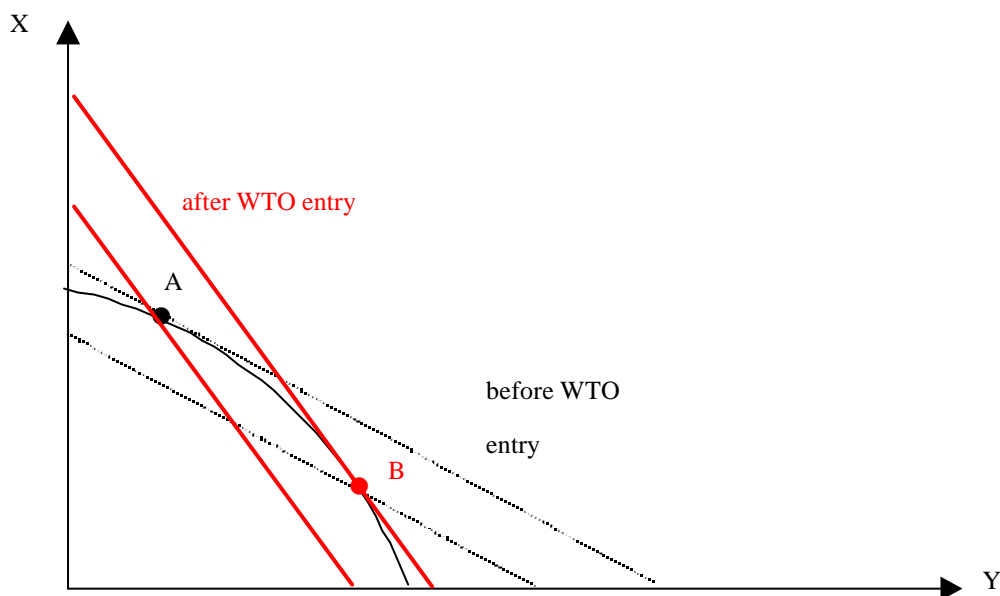
As can be seen in chart 2, the revenue maximizing mode of production before WTO entry is in point A (that is where the production possibility curve is tangent to the highest iso revenue line possible). There is a comparatively large volume of x being produced while y has a significantly smaller share in overall output. The flat position of the iso revenue line implies that good y commands a lesser price than x.

With the WTO entry and the introduction of world market prices the relative prices of goods x and y are changing. We assume the price of y to rise in relation to x which manifests itself in a steeper slope of the iso revenue lines. The revenue maximizing mode of production chosen before the WTO entry is now only located on an inferior iso revenue line. The enterprise is therefore forced to alter its production process in order to maximize its revenues. This optimum now lies in point B, where y commands a larger share in total output. This restructuring of the production process will involve significant costs as we can assume that – at least in the short run – real and human capital cannot be reallocated. There exist positive sunk costs. But despite of this extra cost burden, the restructuring is necessary as the enterprise would otherwise face permanent competitive disadvantages vis-à-vis enterprises that have long since adapted their production structures to the global price relations. The final consequence of an unwillingness to change the production mode or an overly time consuming adaptation process would be the expulsion from the market place caused by a lack of competitiveness.

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<sup>4</sup> We assume a putty-clay constellation, i.e. once erected production capacities cannot easily be modified (e.g. in response to changes on the demand side) as there does not exist a substitutability of production factors any longer. For an earlier application of this model on the German re-unification see Sinn / Sinn 1993.

**Chart 2: The revenue-maximizing product-mix before and after WTO entry**



The pressure to restructure as described here will be particularly strong with respect to Chinese enterprises, while being less pronounced in other world regions. Intensities will vary according to industry sectors and the state of development of the economies concerned.

In order to estimate the intensity of the restructuring pressure that will last on the various industries the following parameters have to be taken into account:

- the variance of protection in the Chinese market against foreign competitors before and after WTO entry
- the variance of protection in the home market against Chinese competitors before and after WTO entry

which has to be weighted with the

- degree of globalization of the products concerned
- share of value added in China.

The sectors identified in such an analysis as the most affected by China's WTO entry are agricultural products, apparel & textiles, electronic goods, leather goods (shoes etc.), motor vehicles & parts thereof, service industries (banking, insurance, telecom, tourism, passenger air transport) (Roland Berger & Partners 1999; Perkins / Shaw 2000).

## *Implications for the Global Exchange of Goods*

The changes in the relative prices of goods and factors described above will have a marked impact on the structure of the global flow of goods and the Chinese role therein.

### Trade Volume Effects

The elimination of barriers to trade in China as well as in the EU, Japan, the United States of America and other trade partners world wide will lead to a massive increase in China's trade volumes.<sup>5</sup> The increase in trade volumes will benefit most participants, most of all the Chinese consumers which will be able to choose from a larger variety of higher quality goods at lower prices.

The rising Chinese import and export volumes, however, will not go along with corresponding net-increases in world trade, but will to a certain degree substitute existing trade flows. Such crowding-out effects will first of all affect economies which are in a similar stage of development as China and compete with her in the world markets. The strongest pressure will therefore last on comparatively underdeveloped economies in Southeast Asia, Latin America and Eastern Europe.

Industrialized economies are expected to increase their export volumes as they will be able to profit from better access to the Chinese market while not facing increasing competition by Chinese exporters in other markets. German exporters are expected to profit disproportionately. During the 1990s about one half of Germany's China-bound exports were bought by Foreign invested enterprises located in China. The expected FDI boom (see below) may therefore first of all promote German exports to China.

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<sup>5</sup> The PR China is already today a major trading nation. According to the latest WTO statistics, the PR China has in 2001 overtaken Canada as the fourth largest trading nation in the world – the third largest, if the EU is not taken as a unified economic entity. See Table A1 in the appendix.

### Terms of Trade Effects

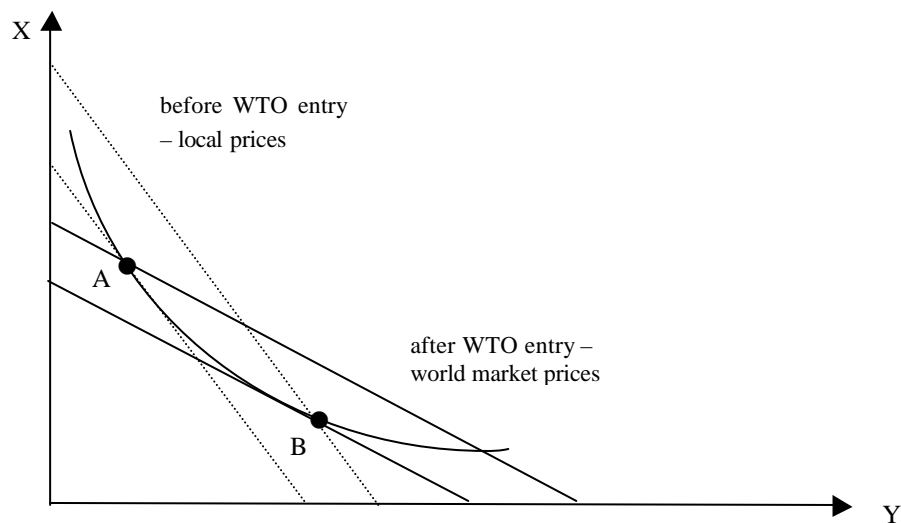
The changes in the relative price structures and the resulting re-direction of global goods flows will also have an impact on the terms of trade.

The expected increase of Chinese exports will lead to a reduced scarcity of China's main export goods on the world market<sup>6</sup> and therefore reduce their prices. At the same time the expected import surge of Chinese economic actors will bring about an increase of the prices of China's main import goods as – at least in the short term – scarcity is going to increase. Therefore the terms of trade of industrialized economies like the EU and the USA are going to improve as their imports become cheaper and their exports are expected to command higher prices. This development will not remain confined on bilateral EU (US etc.) – China trade relations but will apply to all transactions in the goods concerned as arbitrage processes will lead to price corrections world wide.

### *Global Factor Re-allocation*

The impact of changes in the relative prices caused by China's WTO accession will not remain confined to the goods level but affect factor prices as well, and cause production capacities (factors) to be re-arranged and re-allocated on a global scale. Chart 3 depicts the micro-economic ratio of these processes.

**Chart 3: The cost minimizing factor / input-mix before and after WTO entry**



<sup>6</sup> It is expected that no longer competitive suppliers from other world regions will only after a certain period of time leave the market and therefore for some time there will exist excess production capacities and an oversupply in the respective goods

Chart 3 transfers the considerations, which in chart 2 had been made with respect to changes in the relative prices of goods, to the level factor prices (i.e. production factors in the terms of capital, technology and labor, the same considerations are, however, relevant for production inputs like energy, raw materials, intermediate products). The dotted (uninterrupted) lines in chart 2 depict the iso cost lines of a Chinese enterprise before (after) the WTO entry. These iso cost lines show alternative combinations of the factors x and y which involve the same costs. The closer a line lies to the origin the lower the overall cost level. The convex curve represents the iso production indifference curve of the enterprise, i.e, alternative production processes resulting in the same output volume.

Before the WTO entry the cost minimizing combination of production factors (production processes) was located in point A. It is here that the iso production indifference curve is tangent to the lowest iso cost line possible. As can be seen in this situation the price of factor y was relatively high in comparison to factor x, therefore the enterprise chose a production process which involved an extensive usage of factor x, while factor y was employed only sparingly. With the WTO entry and the resulting integration in the world market the enterprise suddenly faces new factor price relations: With the acceptance of world market prices the relative price of y decreases. In order to minimize its production costs (at any given output level) the enterprise is now forced to readjust its production processes and employ more units of factor y than before (point B). Once again it has to be pointed out that this readjustment will involve considerable costs, but the enterprise cannot refrain from executing the readjustment if it wants to prevent a permanent weakening of its competitiveness.

Capital as the production factor with the highest mobility will make the greatest contribution to the accommodation of these new price structures. And as China has not yet attained capital convertibility it will be foreign direct investment flows (FDI) which will have the greatest impact.

#### Impact on the Global FDI Flows

Improved market access and a general liberalisation of the economic regime governing foreign invested enterprises will induce an upsurge of China-bound FDI. According to UNCTAD estimates, the FDI inflows to China may more than double to \$100 billion a year in 2006 (UNCTAD 2000).



China is already today the largest host economy for FDI in the third world. Between 1995 and 1999 China absorbed 7.5% of global FDI flows and about one quarter of all FDI flows directed towards developing countries. In the years 1993 to 1996 China was even host to more than one tenth of global FDI. The accumulated FDI stock of China amounted to more than 6% of the global total in 1999. And with its WTO accession the attractiveness of China for foreign investors will improve even further.

### Non-FDI Capital Flows

In the short run the Chinese WTO accession will not have a major impact on the direction and structure of global non-FDI capital flows. The reasons are obvious. The Chinese Renminbi is inconvertible on the capital account and the Chinese financial sector is certainly not on par with international standards and business practice.

In the mid-term, however, the Chinese financial sector will have to catch up with international best practice as the availability of state-of-the-art financial intermediation will be the key for a successful WTO membership and long-term growth because:

- the enterprise sector's international competitiveness relies on the availability of modern financial services,
- the attraction of capital from the world capital market - at reasonable costs - relies on modern financial institutions,
- in a market economy macro-economic stability is based on sound financial markets.

These necessities will speed up the modernization of China's financial system and by doing so create the preconditions for full convertibility.

Looking even further into the future China may become the dominating actor on the global capital markets in a few decades (Hu 1999) as demographic developments will force China to attract substantial amounts of capital from abroad if it wishes to keep its investment ratio on its present height.

### **3. Impact on Sino-US and EU-China Economic Relations**

The developments described above will have a profound impact on China's economic relations with the US as well as the EU.

#### *Sino-US Economic Relations*

China is certainly not a minor trade partner for the US economy. According to US statistics for 2001 China is today the fourth largest import market for the US (102,069.3 mill. US\$; 9.0 % of total imports) and the ninth most important destination for its export industry (17,959.0 mill. US\$; 2.8 % of total exports). According to this statistics the US trade deficit with China is the largest the US uphold with any country.<sup>7</sup>

And the economic relations between the US and China are expected to experience a further substantial intensification in the aftermath of China's WTO entry. At first the WTO-effect will be felt in structure and volumes of the bilateral trade flows. Caused by the dismantling of tariff and non-tariff barriers to trade, the exchange of whole product groups will suddenly become economically rational, which until then were not considered as profitable.

An analysis of the composition of Sino – US trade flows highlights the fact that those Chinese import goods that will be most affected by the WTO accord have in the past commanded only a very small percentage of overall US exports to China. It is especially in these areas that massive increases in US exports to China can be expected (notably automotive and grain). On the other hand when looking at the Chinese exports to the USA it becomes obvious that those categories that will be affected most by US concessions in China's favor already command rather large shares in overall US imports from China. The potential for further increases in US imports seems therefore rather limited (Schmidkonz / Taube 1999).

We therefore see a considerable potential for China-bound US exports, especially in the areas grain, automotive, pulp and paper. On the US import front crowding out effects induced by the dismantling of protectionist barriers against imports from China are expected first of all to hit suppliers from other parts in the world (incl. Mexico) and less American producers. All in all it

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<sup>7</sup> United States International Trade Commission, <http://dataweb.usitc.gov>. Seen from the Chinese perspective, the US is even more important as a trade partner for China, absorbing 20.4 % of the country's exports and providing it with 10.8 % of its imports (MOFTEC).

seems quite possible that in the post WTO accession era the US' trade balance deficit with China will experience some improvement.

US FDI to China, which has recently contributed about 10 % of China's total yearly FDI inflows (see table 1 below), has until now mostly been “resource seeking”. It has been attracted by the low cost of production in China and less by the actual size and potential of the Chinese market. Consequently a considerable share of FIE production has been exported, and not been sold on the Chinese market. This situation, however, is going to change as in the near future market seeking foreign enterprises that can be expected to increase their commitment to the Chinese market considerably. Due to more liberal FDI regulations resulting in better access to the Chinese market, and rising purchasing power of Chinese customers the character of FDI is already changing gradually. Market seeking FDI is becoming more important and is expected to become the main mode of China-bound FDI in the run of her WTO entry process (Lemoin 2000).<sup>8</sup>

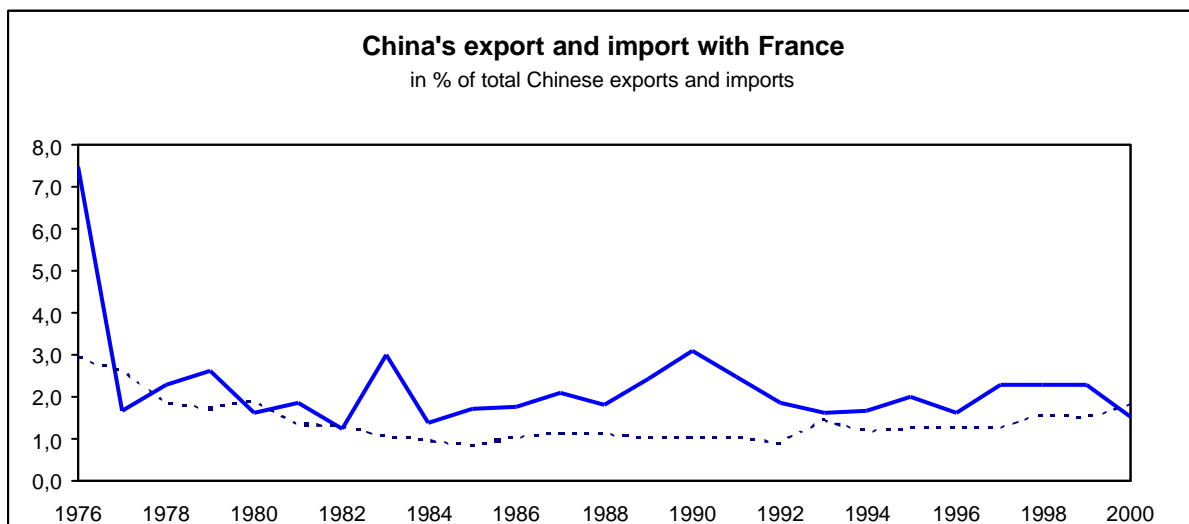
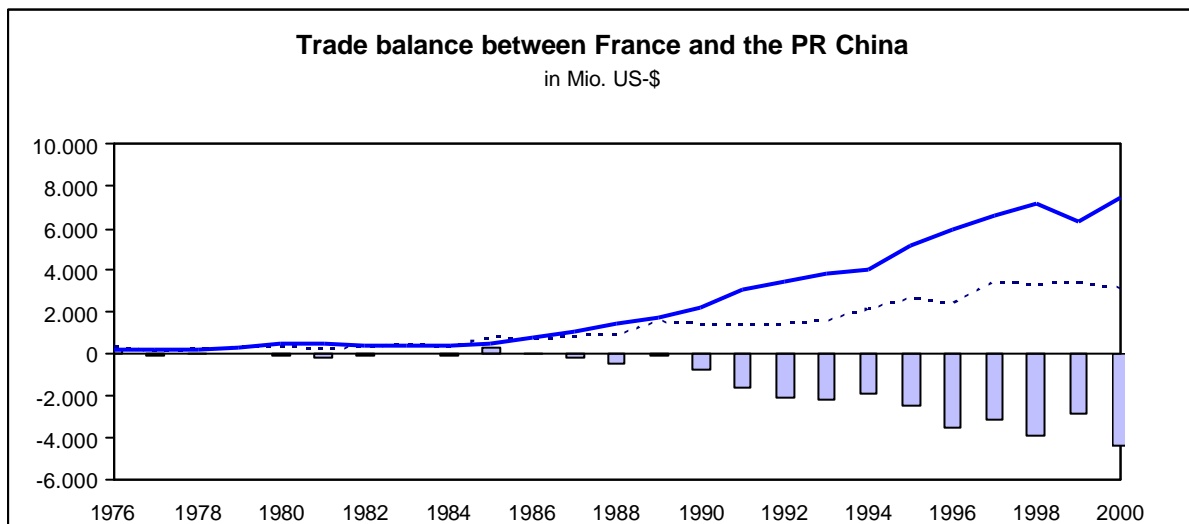
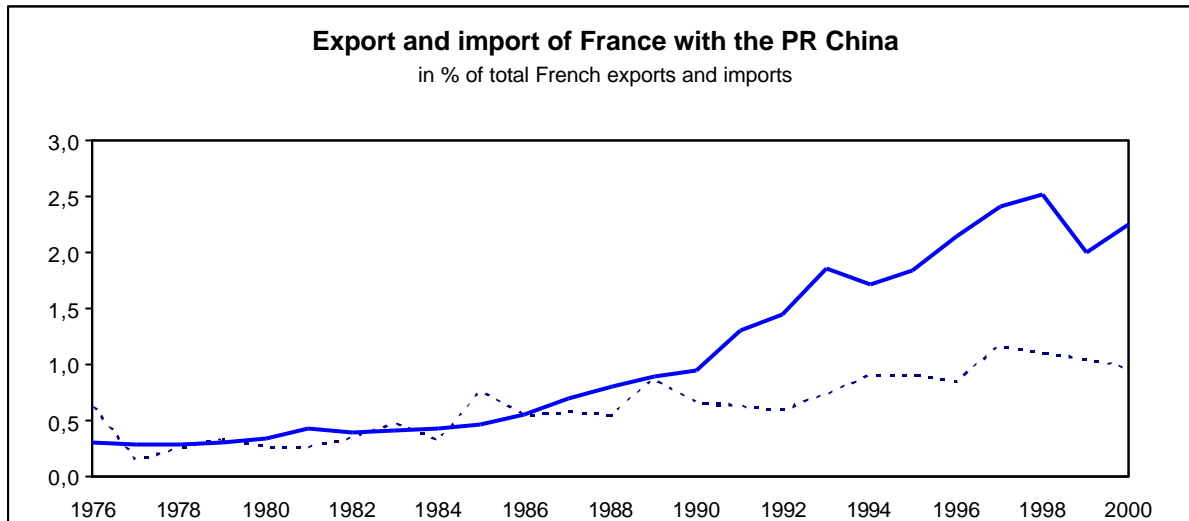
#### *EU-China Economic Relations*

Today the EU is a much more important trade partner for China than China is for the EU. This imbalance, however, is changing with China's importance as a trading partner for Western Europe rising steadily. In the course of these developments, however, China is becoming much more important as a market to source imports than as an export market for Europe. When looking at the corresponding data from the perspective of China, i.e. the importance of the European countries for Chinese exports and imports, the picture is much more diverse. The general impression, however, is that most Western European countries have lost some of their relative importance as trading partners for China (Taube 2002). Charts 4-5 depict these developments paradigmatically for France and Germany.

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<sup>8</sup> These developments will alter the overall composition of FDI inflows. They will be less export-oriented, feature a higher technology content and come along with much more spill-over effects than FDI in the past. All this will boost economic development in China – if the institutional framework is right and the development of an entrepreneurial local enterprise sector is promoted (i.e. unrestricted access to capital market, business licenses etc.) (Ögütçü/Taube 2002).

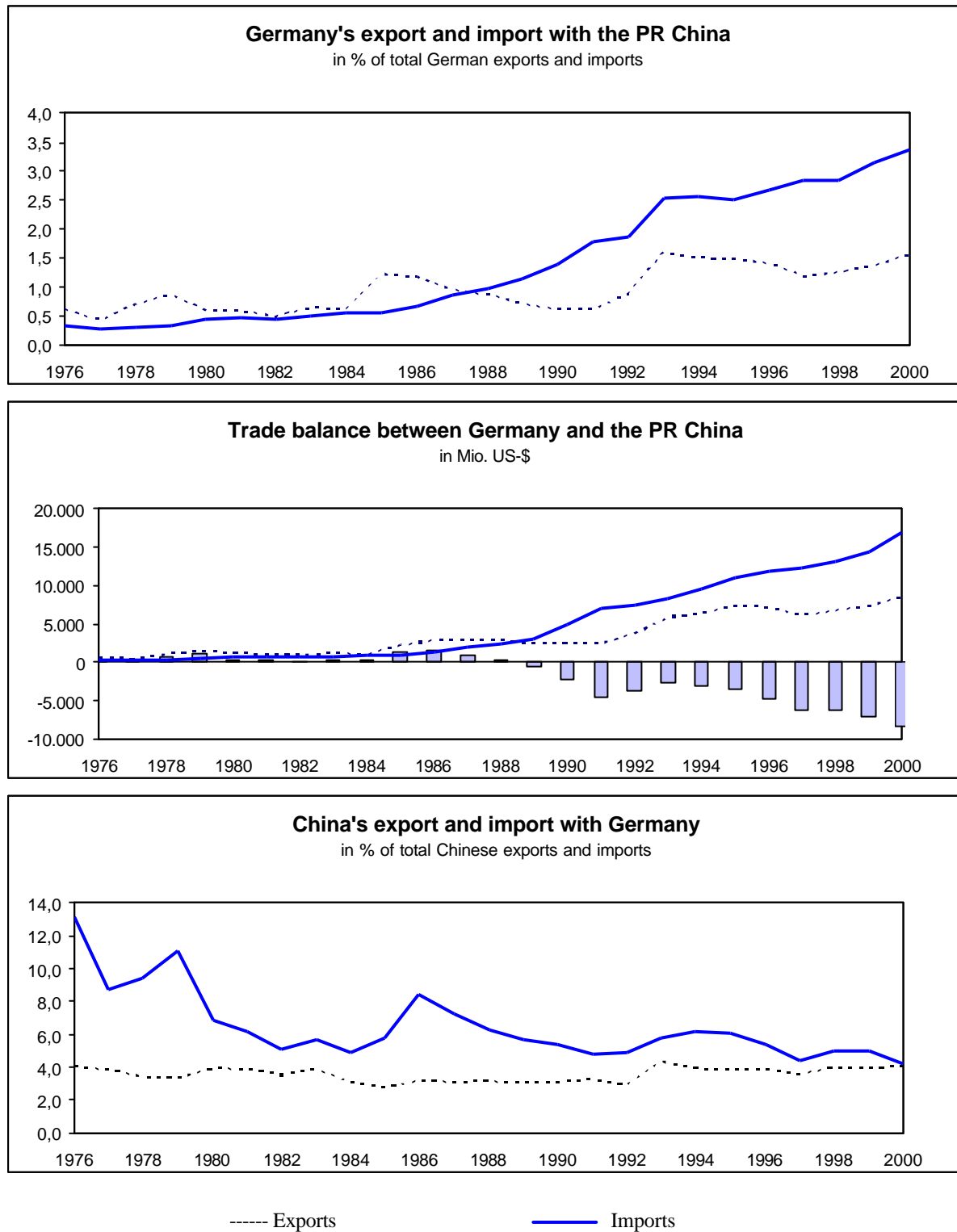
**Chart 4: Indicators of trade relations between France and the PR China**



----- Exports                      ——— Imports

Source: International Monetary Fund, Direction of Trade Statistics Yearbook, Washington, various years.

**Chart 5: Indicators of trade relations between Germany (FRG) and the PR China**



Source: International Monetary Fund (various): Direction of Trade Statistics Yearbook, Washington.

Note: Until 1990 the data covers West-Germany's trade relations with the PR China only.

From 1991 on the data refers to the re-unified Germany.

The same incongruous relationship will be observed with respect with China's role as a host country for European FDI. Today about 10 % of China's FDI inflows originate in the EU (see table 1). These investments are of rather high importance for China as European FDI are known to be much more capital intensive and go along with the introduction of younger vintages of technology than the bulk of China's FDI inflows originating in Asia. The development impulse associated with European FDI is therefore considered to be very considerable. Seen from the perspective of the EU and its member states, however, China is still of minor importance as a host country for European FDI. On average less than 1 % of the EU member states' FDI outflows are directed towards China.<sup>9</sup>

**Table 1: China-bound FDI by country of origin as a percentage of total FDI inflows to China**

	1990	1995	1998	2000	2001
<i>World (in billion US\$)</i>	3,487.11	37,805.69	45,462.75	40,714.81	48,840
EU-12	4.5	--	--	--	n.a.
EU-15	--	5.7	8.8	11.0	n.a.
France	0.6	0.8	1.6	2.1	1.1
Germany	1.8	1.0	1.6	2.6	2.5
Italy	0.1	0.7	0.6	0.5	0.5
Netherlands	0.8	0.3	1.6	1.9	1.6
United Kingdom	0.4	2.4	2.6	2.9	2.2
Hong Kong	60.7	53.8	40.7	38.1	34.2
Japan	14.4	9.0	7.5	7.2	8.9
Singapore	1.4	4.9	7.5	5.3	4.4
Taiwan	--	8.4	6.4	5.6	6.1
USA	13.1	8.2	8.6	10.8	9.1
Virgin Islands	n.a.	0.8	8.9	9.4	10.3

*Source:* Calculations on the basis of data from: Guojia tongji ju [National Bureau of Statistics] (various): Zhongguo tongji nianjian [China Statistical Yearbook], Beijing, and: China Monthly Statistics.

Since about one decade the Sino-EU economic relations, however, have reached an intensity that leaves an imprint on the economic structures of *both* economies (Taube 2002).

In terms of the intensity of the division of labour the FDI boom in the 1990s has come close to a quantum leap in the bilateral relations between most European economies and China. As FDI represent the simultaneous transfer of capital, capital goods, and human capital they embody a much broader range of exchange than ordinary goods trade. It is not only (fabricated) goods that

<sup>9</sup> The major portion of the direct investments of the EU-15 countries remains within the borders of the EU or

are exchanged, but factor endowments, i.e. production capacities. New factor combinations and an improved exploitation of comparative advantages become possible, inducing a reconfiguration of relative prices, a redirection of trade flows – and mostly increasing trade volumes as well –, and eventually an acceleration of structural change.

The global, and as part of them, the European FDI-flows to China have significantly contributed to economic growth and development in China. And although their China-bound FDI flows have on average amounted to only about one percent of their overall FDI outflows they have also exerted considerable influence on the European economies and their interaction with other actors in the world economy. The cutback of labour intensive industries in Europe, like shoes, textiles etc., has been accelerated while the capital and technology-intensive sectors have received a development push. All this has of course been accompanied by frictions on the labour market.

The structure of European imports has been strongly influenced by the production of European FIEs located in China, that are (mostly) taking advantage of low labour costs in China and are now producing in China for the European market. In addition there has been a considerable trade diversion effect when production facilities were moved from Hong Kong, Taiwan and South East Asia to China, which changed the regional composition of European import structures.

European exports have on the one hand experienced a stimulus by FIEs located in China which have become major clients for European suppliers, absorbing the largest part of Europe's China-bound exports. But there have also been strong diversions of trade flows. Although Eastern Europe may be the preferred location for West European export processing businesses targeting the European market, European production plants have also been moved towards China, from where they supply customers in Asia and the Americas. In addition, more and more European enterprises are implementing globalisation strategies based on the concept of only one large production site in Europe, the Americas and Asia each, and many are choosing China as their Asian location – thereby substituting European exports into the region.

The effects described here will become even more pronounced with China's accession to the WTO and the ensuing liberalization processes.

The elimination of barriers to bilateral trade in China as well as in the EU will almost certainly lead to a substantial increase in bilateral trade volumes and advance the relative importance of

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flows to the U.S. or to Japan (i.e. it remains in the confines of the Triad).

China for the European economies. This will go along with a comprehensive reshuffle in the composition of imports and exports as falling tariff and non-tariff barriers will substantially alter relative prices. In the run of these developments the major West European economies' negative trade balances with China will probably expand, although only slightly, as terms of trade effects will act in favour of the industrialised economies. This rather positive evaluation does not apply to the less developed economies in the EU and even less for the East European economies (EU member candidates). They will lose some of their present transaction cost advantages vis-à-vis China and may encounter a new competitor on the West European markets. The changes in relative prices caused by China's WTO-entry will induce a re-arrangement and re-allocation of production capacities (factors) on a global scale. In this run processes of structural change already under way in Europe will be forced to increase in speed, and it will be Europe's most underdeveloped and structurally underprivileged regions that will have to bear the strongest pressure.

At least West European enterprises are expected to (re-)locate production capacities to China, and at least part of it will not constitute net additions to their global production capacities but be at the expense of European locations. Improved market access and a general liberalisation of the economic regime governing foreign invested enterprises will induce an upsurge of China-bound FDI. West European enterprises can be expected to increase their commitment to the Chinese market considerably.

In so far as foreign invested enterprises have been absorbing the majority of European and especially German exports to China, the rising inflow of FDI into China is expected to stimulate the European export industry. However, these considerations apply only in terms of the net-effects of the overall developments. First of all the low-tech segments of Europe's China-bound exports can be expected to be substituted by local productions.

The overall effect of China's entry to WTO on European GDP, however, will be minor. Various quantitative analysis show a positive impact of about 0.1-0.2 %points in GDP growth. Germany may experience a slighter larger growth-boost if the trade stimulating FDI-effects outlined above should materialize.

Welfare effects on various groups of the population will of course vary considerably. Those groups who derive most of their income from industries prone to be dismantled in Europe due to changing goods and factor price relations (i.e. comparatively labor intensive industries) will



experience net-welfare losses. Processes of structural change already under way in Europe will be forced to increase in speed. It will be Europe's most underdeveloped and structurally underprivileged regions (EU-expansion candidates!) that will have to bear the strongest pressure. Germany's eastern regions may be negatively affected. As a result of the anticipation that Europe's most under-privileged regions would suffer most, an additional migration pressure towards Europe's industrial growth centers has to be expected.

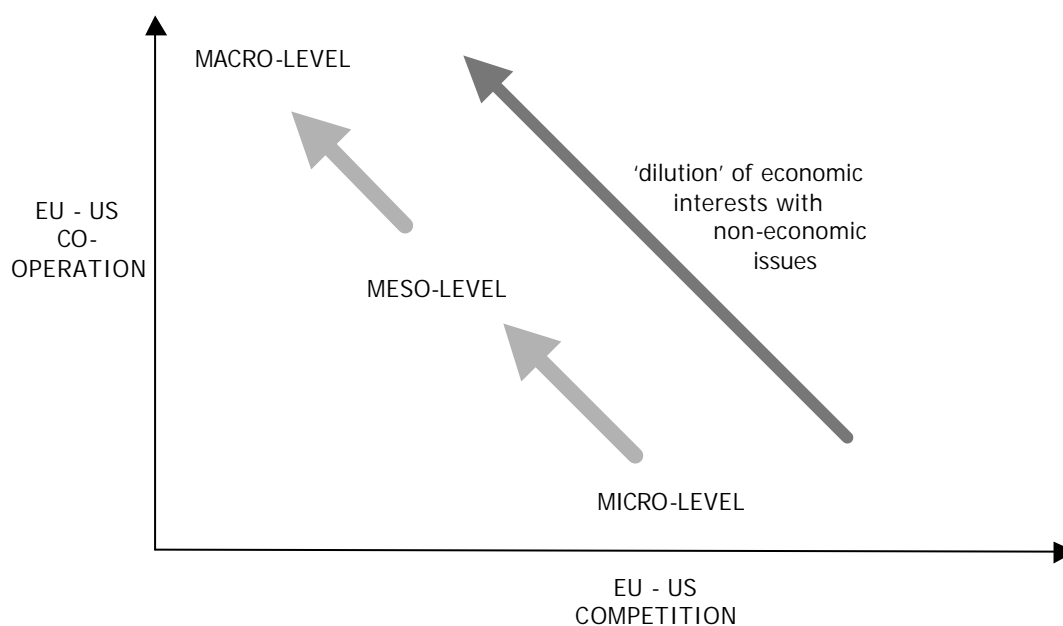
#### **4. Shared Goals and Competing Interests of the EU and the USA in the Chinese Economy**

The overview of changes in China's economic relations with the EU and the US brought about by its WTO accession presented above has highlighted on the one hand the expectation of a massive intensification of economic relations and on the other hand pointed at substantial structural changes in the economic division of labor between the three economies and the world economy in general.

Analyzing the respective goals and objectives of the EU and the US in the Chinese economy it becomes obvious that there exists a broad range of common interests. But only a minority of these shared goals will lead to concerted action, while the majority of the shared interests will manifest themselves in strong competition

Concerted action can be expected only where there is no rivalry in the consumption of the concessions or alterations in the institutional setting Chinese decision makers will be asked for (e.g. increased transparency, rule of law, better protection of property rights). But even in the field of improvements in the institutional framework there exist substantial conflicts of interest between the EU and the US. All in all we may postulate that the potential (and empirical evidence) of EU-US cooperative behavior increases the further we leave the level of individual (economic) actors and economic interests become intertwined with non-economic issues (chart 6).

**Chart 6: EU – US Cooperation and Competition at Various Levels of Interaction**



At the **micro-level**, where individual companies are competing for market shares there is no cooperative behavior to be expected. Individual enterprises are competing for market shares and try to realize maximum arbitrage profits. This may be the most dynamic segment of Sino-US / EU relations.

EU – US corporate interaction in China will be characterized by intense competition. The China engagement of European and US corporations is grosso modo based on the same aims and strategies. Both will try to increase their market shares in the Chinese market before its structures have become too rigid. The transitional period granted to China after its formal entry to WTO may pose the last chance to position an enterprise in the Chinese market before market shares are distributed. Once these market structures are established, latecomers will be forced to commit disproportional higher financial and management resources, in order to establish their presence in the Chinese market. Therefore it is the long-term interest in the Chinese market that will motivate these capital flows rather than the short-term profit. And although we should take into account that there will be some different foci on industries,<sup>10</sup> we can expect a period of intense competition between EU and US corporations (as well as Chinese and other companies) in and for the Chinese market.

At the **meso-level**, where individual enterprises join forces in order to promote common goals

<sup>10</sup> All industries, however, will experience an intensification of competition as the phasing out of restrictions on distribution and distribution services for most products will open a new dimension of competition that until now had been closed for foreign invested enterprises (Perkins / Shaw 2000).

vis-à-vis administrative bodies entrusted with the rule-setting for and regulation of specific markets, a much higher degree of cooperation is possible. However, here too intense competition between EU and US lobby organizations has to be expected whenever structural differences or different technological standards (systemic solutions)<sup>11</sup> in the EU and the US prevent a transatlantic win-win constellation. But on the other hand, we may also observe some EU free-riding on US lobbying at the meso-level (Groombridge 2001). The heterogeneity of industrial structures and interests within the EU economic area weakens its ability to create powerful lobby organizations [here we include *expressis verbis* administrative bodies established by the EU commission] and promote particular industry interests. Free-riding on the strong US lobby groups may be the only recourse for some European enterprises.

In the run of the bilateral negotiation rounds with China about the conditions of her accession to the WTO the different interests of EU and US industries have already become quite obvious. While the EU has been stressing that the Sino-US had covered about 80% of their own demands, from the EU's perspective there still remained substantial shortcomings.

Naturally, the US had been fighting for their own interests: for oranges where the EU grows mandarins, for bourbon whiskey where it sells Scotch and Cognac, for plastics where the EU is more interested in cosmetics. In addition, certain special provisions needed by the US in order to protect certain sectors of the US industry were considered unnecessary by the EU. The EU's main goal in the negotiations following the US deal has therefore been:

- to press for euro specific concessions, in particular in the tariff area: for spirits, cosmetics, ceramic, leather, textiles, footwear, marble and stones, machinery etc., and
- to improve the US deal on those points where the EU had a particular interest and where Washington might have obtained more if it had not concentrated all its efforts on provisions of particular benefit for its own national clientele (Beseler 2002).

This latter aspect applies especially to the format of potential anti-dumping procedures against China. While the EU has long since agreed to classify the Chinese economy as a "non non-market economy" and thereby making it eligible for a procedure that takes some specific

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<sup>11</sup> Systemic solutions are understood as complex technological systems that command a fixed set of complementary products. Implicating that once the decision for a certain system and its industrial standards has been made complementary goods will automatically be requested by the host country, while other systems and their complementary products remain excluded. Examples for competing systemic solutions are in the telecommunications sector the GSM and CDMA technologies, in the transport sector the Transrapid versus the Shinkansen system etc.

characteristics of the Chinese economy into account, the US has pressed to be allowed to stick for further 15 years to a procedure developed for dumping charges against centrally planned economies. The Chinese agreement to this claim had to be 'bought' with concessions in areas of less concern for the US negotiators.<sup>12</sup>

It should, however, not be forgotten that both US and EU negotiation teams were perfectly conscious of the fact that they had much to lose if China would succeed in playing them off against each other. Therefore various instruments were used to coordinate the bilateral negotiation efforts, including regular personal meetings, routine information exchanges regarding Chinese negotiation strategies as well as EU and US positions on particular negotiation issues.

The area with the most extensive range of EU / US common interests vis-à-vis China is located at the **macro-level**. It is the level where economic policy becomes embedded in a broad range of non-economic policy issues.<sup>13</sup> The EU and the US have common interests with respect to the general developments in China. The creation of new economic freedoms, the promotion of the rule of law, the prevention of rising nationalism in China as well as greater regional stability in East Asia caused by a more calculable China etc. are all in the common interest of the EU and the US and are issues dominated by cooperative efforts and joint action.

The EU however has also got its own interests in China and Asia in general. It is open to discussion if the EU is a rising power – as China would like to see itself – or rather a group of nations desperately trying to preserve past glory, but it certainly is not content with being the junior partner to the US. As such the worst case scenario for the EU would be the genesis of a unipolar Asia-Pacific (pacific-rim) economic growth center which would leave the EU at the periphery of the world economy, thereby reducing its relative economic power and potential influence in the world arena. Therefore the EU will remain involved and try to increase its stakes in the region – if necessary to the detriment of the US.

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<sup>12</sup> For details see Schmidkonz / Taube 1999.

<sup>13</sup> Charlene Barshefsky e.g. has described the American interests in China's WTO accession as follows:

"China's WTO accession is a clear economic win for the United States. [...] But China's accession also has deeper implications. Our relationship with China, given China's size and economic weight, affects all of America's foreign policy and security goals in Asia: from broad strategic interests to regional issues in Korea, Southeast Asia and elsewhere; human rights and religious freedom; weapons proliferation; environmental issues; labor rights; crime and narcotics trafficking; and many others. We have serious differences with China in a number of these issues, and have found areas of common ground as well. And we have a fundamental responsibility to develop a stable, mutually beneficial relationship in which we act upon areas of shared benefit and mutual interest. WTO accession will allow us to do so, as it complements and supports long-standing American goals in China policy" (Barshefsky 2000).

## **5. Conclusion: Transatlantic Competition and Cooperation vis-à-vis China**

Analyzing the complex trilateral relationship between China, the US and the EU we have been able to identify areas of EU-US cooperation vis-à-vis China as well as such characterized by intense competition. *But all in all we can expect competition to be the leitmotiv of EU – US interaction in China.*

The outcome of this competitive process is open. On the winning side, however, we will certainly find China. In the past the Chinese side has already proven her ingenuity in making the best use of competition between European and American enterprises, squeezing them to make a maximum of concessions in terms of provision of state of the art technology, R&D facilities etc. while keeping prices low. The process of opening the Chinese telecom market to foreign enterprises constitutes an example in place. Any decisions in favor or against specific systemic solutions (e.g. CDMA or GSM technology), which would result in a certain dependence on the provider, have been postponed as long as possible or leveraged in so far as the competing technologies are allowed to exist at the same time but in different market segments – making a change in technologies less costly.

All in all US companies seem to have won the first round in the struggle for the Chinese (and Asian) markets, not the least because they have been able to implant numerous of 'their' systemic solutions in these markets. There actually seem to exist some path dependencies that give US companies a structural advantage vis-à-vis their European competitors. The US leadership in IT technologies, for example, has led to the establishment of IT-standards that will favor US companies for years to come. At the same time the US have won the race for networking with China's next leadership generation. The majority of China's next generation of academic, economic and political elite is being educated in the US, providing the US with the opportunity to establish networks and affinities in her favor. At the same time the European efforts to promote Europe as an alternative education and training center have been rather unsuccessful. Europe is attracting only those who did not have a chance to go to the USA in the first place.

But this competitive either / or juxtaposition of EU and US positions may well be a completely wrong formula for the 21st century. In a "globalized world" and particularly in the post September 11<sup>th</sup> 2001 era, it is no longer possible to neglect the prime importance of multilateral fora for the regulation of international interests and conflicts. And even though the triangular relationship US-China-EU is far from being equally balanced, China, the EU and the US as well,

all need to consider each others policies in order to maximize economic welfare as well as security.

## Appendix

**Table A 1:**

### The world's top traders in 2001

	Exports		Imports	
	Volume bill. US\$	Market Share	Volume bill. US\$	Market Share
European Union	873	18.4	914	18.2
United States	731	15.4	1181	23.5
Japan	405	8.5	350	7.0
<b>PR China</b>	<b>266</b>	<b>5.6</b>	<b>244</b>	<b>4.9</b>
Canada	262	5.5	228	4.5
Hong Kong	191	4.0	202	4.0

Note: It is not permitted to add up the trade volumina of the PR China and Hong Kong as this would result in substantial double counting due to the re-export activities between these two customs territories.

Data: World Trade Organisation (2002).

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