

**Summary:** Despite shared frustrations and interests and some tactical cooperation, Washington and Brussels lack a game plan for future transatlantic relations with China. The United States and Europe have disagreed on the Chinese security challenge, currency manipulation, and current account and trade imbalances. At the same time, the transatlantic allies share similar concerns about Chinese state capitalism, violations of intellectual property rights, a lack of reciprocity on foreign investment, and an absence of Chinese implementation of free trade principles. The impending designation of China as a market economy provides a window of opportunity to leverage a Chinese course correction.

## Continental Rift: Bridging Transatlantic Differences on Economic Policy Toward China

by Bruce Stokes

The European Union and the United States have long been at odds over how best to deal with China. The European desire to sell arms to China in 2005 erupted into a damaging transatlantic row. And at the G20 summit in Seoul, South Korea, in November 2010, European governments refused to back U.S. efforts to press China more forcefully to appreciate the Chinese currency, the renminbi.

While these squabbles have grabbed headlines, they paint an incomplete picture. In recent years, there is reassuring evidence of growing tactical cooperation between Washington and Brussels on trade matters. Moreover, in a global economy, there is a growing commonality of interest between the European Union and the United States on business and commercial issues now that China has become a leading trading and investment partner for both economies. At the same time, there is a shared frustration with Beijing's recent actions constraining the activities and opportunities of European and U.S. businesses in China. And there are a common set of problems that Europe and the United States can work together to

solve, involving Chinese investment, government procurement, intellectual property, and subsidies policies.

Nevertheless, there is a glaring absence of a shared game plan for future transatlantic economic relations with China. Fortunately, a common perspective and the political will to achieve such a strategy may finally be at hand in both Brussels and Washington. If the European Union and the United States fail to seize this opportunity, they may long regret it.

### Differences Galore

The transatlantic gulf in military and diplomatic interests involving China is real and may be unbridgeable. Thanks to geography and history, the United States has Pacific security equities that Europe will never share. It is the U.S. 7th fleet that patrols the South and East China seas, where daily it is at risk of confrontations with the increasingly aggressive Chinese navy. Moreover, it is U.S. warships, not European ones, that could be called to interdict a Chinese invasion of Taiwan. In addition, the United States maintains bases in Japan, South Korea, and on Guam. Europe will never have as many military assets

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in play in Asia. It is for this reason that recent rumblings in Europe about reviving proposed arms sales to China risks reopening an old wound that was deeply injurious to transatlantic relations just half a decade ago.

There is also much that Europe and the United States disagree upon when it comes to economic relations with China. Washington has long pushed Europe hard, to little avail, to back U.S. demands that Beijing allow the renminbi to appreciate in value. Americans note, with frustration, that between 2006 and 2008, when the renminbi was appreciating against the dollar, it was depreciating against the euro. In effect, whatever price Chinese exporters were paying in lost market share in the U.S. market, as their goods became more expensive, they were recouping in the European market as the cost in euros of their exports declined.

In recent months, the renminbi has again appreciated against the dollar and it has depreciated against the euro. To quote the American baseball player Yogi Berra, this looks like “déjà vu all over again”. Why Europeans are not more exercised about paying the price for Beijing’s currency manipulation is not clear to Americans. To be fair, Europeans have raised the exchange rate in bilateral meetings with the Chinese, but they have refused to make the issue a priority. At the G20 summit in Seoul, despite American importuning for stronger language, all the Europeans would agree to in the final communiqué was language calling for exchange rates to be determined by market forces. Absent explicit goals and timetables, this kind of nebulous verbiage has long allowed the Chinese to play by their own rules.

Moreover, the Europeans also opposed a fallback U.S. proposal to set targets for containing current account imbalances, one of the byproducts of currency misalignments, which contributed to the 2008 financial crisis. With the Chinese current account surplus at 5.2 percent in 2010 and rising, many U.S. officials think European opposition to some notional ceiling on such surpluses is shortsighted.

These disagreements highlight transatlantic differences in macroeconomic self-interest and structural differences between the European Union and the United States. In 2009, the European Union ran a €33 billion (roughly \$173 billion) merchandise trade deficit with China, part of a €07 billion (\$269 billion) goods deficit with the world. In

contrast the United States ran a \$227 billion deficit with China, as part of a \$504 billion deficit with the world. Faced with a bigger bilateral and global imbalance, and a China deficit that rose 23 percent to a new record \$273 billion in 2010, Washington feels a greater sense of urgency about its “China problem” than does Brussels.

Moreover, the European Union’s member states disagree about China. Southern European states, whose textile, shoe, and apparel industries face devastating competition from Chinese exporters, have been more vocal about the renminbi than Germany, which also does a brisk export business with China in high-end machinery and automobiles. Powerful German businesses do not want to upset their Chinese customers. These differing macro- and micro-economic interests are unlikely to change any time soon.

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The pace of recent Chinese appreciation is still not satisfactory to the United States. Nevertheless, the Obama administration seems reluctant to push this issue much further. U.S. Secretary of the Treasury Timothy Geithner has noted that recent renminbi appreciation, roughly 6 percent at an annual rate, is actually much higher on a real adjusted basis after accounting for current Chinese inflation. And in early February 2011, the Treasury again declined to name China as a currency manipulator in the department’s long-delayed semi-annual report to Congress on currency manipulation.

In the wake of Beijing finally beginning to move on renminbi appreciation, if only to stem domestic inflationary pressures, and given the administration’s demonstrated

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inability to convince its allies to join it in a concerted effort to accelerate that appreciation, the United States seems to be lowering the flame under the currency issue. De-escalation does not signal economic appeasement. But it will remove a neuralgic irritant in transatlantic relations. And it will open the door to greater EU-U.S. cooperation on a range of issues of commercial importance to businesses on both sides of the Atlantic.

### A Growing Similarity of Interests

Recent headline-making disputes over the exchange rate and current account imbalances have masked a convergence of public concern about China in both Europe and the United States. A plurality of both Americans (49 percent) and Europeans (48 percent) now see China as more of a threat to jobs and economic security than as an opportunity for new markets and investment, according to the 2010 German Marshall Fund Transatlantic Trends survey.<sup>1</sup>

Moreover, senior officials in both Brussels and Washington now share a sobering consensus that over the last eight years, since the current Chinese government of Hu Jintao took power in 2002, Beijing has reasserted greater state control over the economy. What has emerged is a state capitalism with Chinese characteristics shaped by government subsidies, foreign investment restraints, and restrictions on public procurement. This development contradicts official expectations in both Washington and Brussels of Beijing's trajectory when China joined the World Trade Organization in 2001 and ostensibly embraced Western free market values.

In the 1990s, domestic Chinese economic reformers pushed for WTO membership, hoping to use international pressure to help them in their struggle to achieve needed internal change. The mistake the West made at that time was to presume that a tactical decision made by a small clique in Beijing reflected a broader strategic commitment on the part of the Chinese government to use WTO rules as a guide for future policymaking. For the most part, the Chinese have been scrupulous in adhering to the letter of their WTO commitments. But experience suggests that they have no intention of using the spirit of their WTO commitments — contestable markets and a limited role for government in the economy — to set the future course for their

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economy. (In fact, some Chinese find it a quaint Western conceit to think that they would.)

As it has become increasingly clear to U.S. and European officials that China has no intention of becoming more like the West, frustration has mounted in Washington and Brussels. “Even when Chinese leaders make strong statements of principle to take action on an issue of concern,” said U.S. Secretary of Commerce Gary Locke in a speech in early February in New York, “those principles don’t always turn into binding law. And even if those laws are written, actual implementation at the local or provincial level is often left wanting.”

This is not a new issue. For years, Americans and Europeans have been complaining about Chinese failure to implement their international commitments to protect intellectual property rights. But as the exchange rate issue moves to the back burner and as the frictions between Chinese state capitalism and Western capitalism mount, it is time for greater cooperation between Brussels and Washington in dealing with Beijing's noncompliance with international trade and investment norms.

The most pressing issue is foreign investment. European and American firms face investment caps, forced joint venture partnerships and other restrictions in the Chinese market. At the same time, Chinese investment in both

<sup>1</sup> <http://www.gmfus.org/trends/2010/index.html>

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Europe and the United States is just beginning to take off, raising concerns about the national security and economic implications of such investments.

Brussels and Washington need to negotiate investment rules of the road with Beijing. The first principle should be reciprocity of market access. If China refuses to allow majority foreign ownership of firms in certain sectors of its economy, then Europe and the United States should deny Chinese investors that same access. The slow growing U.S. and EU economies unquestionably need Chinese capital. The Chinese will attempt to exploit that weakness if the West allows them to do so. Washington and Brussels need to make it clear that their goal is to open the Chinese market, not close the American and European markets. But they also have to be ready to mirror Chinese investment restrictions if necessary.

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The second investment principle should be to favor new job-creating investment over mergers and acquisitions. All three societies need job creation more than changes in ownership and management. While the purchase of existing firms often saves them from bankruptcy, it also raises questions about the investor's intentions. Is a company being acquired simply to obtain its technology? Will the acquired firm eventually be shut down? Brussels and Washington should put their thumb on the scale to encourage green field Chinese investment whenever possible. Reciprocity should also frame a transatlantic approach to government procurement involving China. During Chinese President Hu's Washington visit in January 2011, the Chinese promised to make it easier for foreign firms to participate in Chinese government procurement. American and European officials have welcomed this commitment.

But along with the concerns articulated by Locke about Chinese compliance, European Commission officials plan to propose that Chinese firms be denied access to the European public procurement market to the degree European companies have limited access to the Chinese market. How this idea will sit with EU member state governments remains to be seen. In the past, some have opposed this more confrontational approach. But any such action would have greater leverage with Beijing if it was taken jointly by Brussels and Washington.

The United States and Europe also have a shared self-interest in getting on the same page in dealing with China about intellectual property issues. Europe and the United States have both long complained about Beijing's failure to safeguard Western trademarks and copyrights, particularly the piracy of movies and music. But in the last few years, the protection of patents has become a far more insidious and momentous problem.

The proposed Chinese regulation to limit procurement to products using indigenous Chinese intellectual property threatens to deny European and U.S. firms the value of their patents in everything from computer software to pharmaceuticals. Opposition to this proposal has both enraged and united the U.S. and European business communities in an unprecedented manner.

In the joint statement issued by the U.S. and Chinese governments at the conclusion of the recent Hu visit, Beijing promised to "not link its innovation policies to the provision of government procurement preferences." This commitment was welcomed by both U.S. and European officials and business leaders. But experience has taught them to "trust but verify." The Chinese promise is only as good as its implementation. "They have doled out specific chunks of indigenous innovation policy," observed one European official, "but it is still a black box. Will the Chinese just find another way to do the same thing?"

## An Action-Forcing Event

Joint action on shared interests is never easy. And it often requires an action-forcing event to galvanize cooperation. The impending designation of China as a market economy could provide that leverage. In 2001, when China joined the World Trade Organization, the protocol of accession allowed other member nations to treat China as a

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nonmarket economy. This meant that in trade disputes, Europe and the United States would presume that Chinese export prices were not determined by market factors. Effectively this has led to the imposition of higher tariffs on Chinese goods found to have been sold below production costs in U.S. and European markets.

Under the terms of Chinese accession to the WTO, its designation as a nonmarket economy expires in 2016. It will be considered a market economy from that time forward. At that point, Washington and Brussels will lose a certain degree of leverage over Beijing in trade disputes. But, just five years before that deadline, European and U.S. business community complaints about the Chinese government's interference in the Chinese economy are on the rise, not diminishing. There may be more business concern about Chinese state capitalism today than there was when China first joined the WTO.

This poses a looming political dilemma for both Brussels and Washington. How do officials explain to their business constituencies and to their publics that despite evidence of trade-distorting Chinese government subsidies, continued Chinese government ownership of large segments of the economy, and limits on foreign investment in key business sectors, China has somehow become a market-based economy from one day to the next?

Washington and Brussels have five years to convince Beijing to reverse course or face not-unjustified demands at home to deny China market economy legal status, which would put both the European Union and the United States in violation of their own WTO commitments. Given China's policy drift over the last few years, the only hope that Europe and the United States have of influencing developments inside China is to work in transatlantic consort to try to leverage a Chinese course correction. "We need a stronger sense of direction on China," said an EU official. "If we don't find the right cooperation, the Chinese will divide us."

The time for a strategic transatlantic China economic game plan is long overdue. There is a growing shared frustration with the development of Chinese state capitalism. There is a lengthening common list of particular concerns about issues such as investment restrictions, government procure-

ment and intellectual property protection. There is a looming action-forcing event. And the political will in Brussels and Washington to achieve a common China policy may finally be at hand.

## About the Author

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## About the Stockholm China Forum

This is part of a series of papers informing and informed by discussions at the Stockholm China Forum. The Stockholm China Forum is an initiative of the German Marshall Fund, the Swedish Ministry for Foreign Affairs and the Riksbankens Jubileumsfond. It brings together policymakers, intellectuals, journalists, and businesspeople from Europe, the United States, and Asia on a biannual basis for an ongoing and systematic dialogue to assess the impact of China's rise and its implications for European and U.S. foreign, economic, and security policy

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