

# CAN EUROPE AND CHINA SHAPE A NEW WORLD ORDER?

Charles Grant with Katinka Barysch





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## ABOUT THE AUTHORS

**Charles Grant** has been director of the Centre for European Reform since 1998. He previously worked for *Euromoney* and *The Economist*. He is author of ‘Delors: Inside the house that Jacques built’, published in 1994, and numerous CER publications, including, most recently, ‘European choices for Gordon Brown’ and ‘Preparing for the multipolar world: European foreign and security policy in 2020’, both published in 2007.

**Katinka Barysch** is the CER’s deputy director. Until 2002, she worked as an economist and analyst at the Economist Intelligence Unit. Before that she was a consultant and researcher for the European Commission. Recent CER publications include: (as co-author) ‘The Lisbon scorecard VIII: Is Europe ready for an economic storm?’, February 2008; ‘Turkey’s role in European energy security’, December 2007; and ‘Russia, realism and EU unity’, July 2007.



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When we quote an individual in the text, the absence of a footnote indicates that the source is a private conversation.

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# Contents

About the authors

Authors' acknowledgements

Forewords

1	China and the EU in a multipolar world	1
2	A partnership that is not strategic	17
	Box: The EU and human rights in China	28
3	Economic tensions	31
4	China and transatlantic relations	59
5	Priorities for a strategic partnership	69
	Climate change	70
	Weapons proliferation	78
	Africa	82
	Global governance	89
	Box: China and global economic governance	96
6	Conclusion	101

## Foreword



British American Tobacco is delighted to support this perceptive analysis of the EU's relations with China. There is, to put it mildly, considerable interest in the subject and there could well be a great deal at stake. The authors do justice both to the current situation and to what might lie ahead.

The idea that the EU "stands a better chance of convincing China of the benefits of multilateralism than the Americans, who have a tendency to act unilaterally and disregard international bodies such as the United Nations" offers intriguing possibilities, provided that the EU can get its act together. The authors also suggest practical strategic areas on which the EU and China might focus, to begin building a deeper understanding of what a true partnership could bring to both of them.

### **Michael Prideaux**

Director, Corporate & Regulatory Affairs

British American Tobacco

## Foreword

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STRENGTHENING TRANSATLANTIC COOPERATION

The rise of China is now one of the principal strategic issues facing the transatlantic community. While it first assumed prominence during the spat over the lifting of the EU arms embargo, Europeans and Americans are now as likely to encounter China when addressing policy towards Iran, Africa, or Central Asia as when dealing with traditional East Asian security issues.

As China's global reach and impact grows, dialogue and co-operation between Europe and the United States are going to become ever more important for policy-makers on both sides of the Atlantic, if they are going to shape an effective response. The German Marshall Fund is pleased to be supporting and organising a range of events and research exploring these issues, and to have been working with the Centre for European Reform on a number of them. This excellent paper is one of the first to look at EU-China relations in a fully global context and should be required reading for Europeans and Americans alike.

### **Ron Asmus**

Executive Director, Transatlantic Center

The German Marshall Fund of the United States

The German Marshall Fund of the United States is a non-partisan American public policy and grantmaking institution dedicated to promoting greater co-operation and understanding between the United States and Europe.

# 1 China and the EU in a multipolar world

Europe's relationship with China has been mainly commercial. Both sides would benefit from their partnership becoming more political and strategic – and so would the rest of the world. However, rising tensions, over subjects such as trade, climate change and human rights, risk damaging the relationship and disrupting progress towards closer strategic ties.

Both the EU and China are helping to shape a new international order. For many European observers of international affairs, it is obvious that power is shifting from west to east, and that the world is becoming increasingly multipolar. They see a gradual transition from the hegemonic order of the 1990s, when the US was the sole superpower, to a more complicated international system in which several poles – including Brazil, China, the EU, India, Japan and Russia – have weight or the potential to develop it. Many Europeans are rather relaxed about this evolution, though it makes the more Atlanticist among them feel uncomfortable.

Americans, unsurprisingly, tend to be less sanguine about this trend. Given that some of those who have talked most about multipolarity – including the former French president, Jacques Chirac, and the former Russian president, Vladimir Putin – have also, at times, been very critical of the US, Americans can be forgiven for seeing the concept as anti-American.

Economics, and notably the rapid growth of the 'BRIC' economies (Brazil, Russia, India and China), is driving this change. According to predictions by the Economist Intelligence Unit (EIU), by 2020 the

American, EU and Chinese economies will each account for just under 20 per cent of global GDP (calculated on the basis of purchasing power parity). It predicts that by 2030, the Chinese economy will be the largest in the world, while the relative weights of the US and the EU will continue to fall. Although much uncertainty surrounds such figures, the trend seems clear.

#### GDP and population, 2007\*

	GDP, billion \$	GDP per head, \$	Population, m
US	13,843	45,820	302
China	7,168	5,420	1,323
Japan	4,286	33,630	127
India	3,031	2,730	1,110
Russia	2,059	14,460	142
EU-27	14,824	30,100	492
France	2,117	34,630	61
Germany	2,768	33,510	83
UK	2,230	36,580	61

\* GDP figures are calculated at purchasing power parity, a measure that takes account of the lower price level in developing countries.  
Source: *The Economist Intelligence Unit*

Of course, military and diplomatic power does not always correlate closely with economic output. At the moment, the US accounts for almost half the entire world's defence spending, and it is likely to remain the supreme military power for many decades ahead. But there is little doubt that in the long term, the West (in the sense of North America and Europe) is becoming weaker relative to the rest of the world.

#### Share of world GDP (percentages at PPP\*)

	1995	2007	2020	2030
US	21.7	19.4	18.3	16.6
China	5.5	10.1	17.7	22.7
Japan	8.3	6.0	4.6	3.6
India	3.1	4.3	6.9	8.7
Russia	2.8	2.9	3.1	2.7
EU-27	24.5	20.8	18.6	15.6
France	3.6	3.0	2.5	2.1
Germany	5.3	3.9	3.2	2.5
UK	3.4	3.1	2.9	2.5

\* In December 2007, the World Bank's International Comparison Programme released new PPP calculations for 146 countries for 2005; China had fully participated in this survey for the first time. The new data suggest that the emerging economies are much smaller than previously assumed – and the new estimate for China is 40 per cent lower. The EIU's projections are based on the new estimates.  
Source: *The Economist Intelligence Unit*

Newspaper headlines in the past few years have brought home this shift to the European public. Two companies of Indian origin, Mittal and Tata Steel, have bought the two largest steel producers in Europe, Arcelor and Corus, respectively. Chinese and Indian firms have bought up the remnants of what was once the British Leyland car group. And when American and European banks suffered massive losses in the 2007 credit crunch, sovereign wealth funds from China, Kuwait, Singapore and elsewhere bought billion-dollar stakes in banks like Citi, Merrill Lynch and UBS.

The rise of the new economic powers is affecting the fabric of international diplomacy. After the UN General Assembly meeting in September 2007, one EU official commented: “The West is becoming visibly weaker at these events. Countries like Mexico, Brazil, South Africa and India are exerting increasing diplomatic influence, and often choose not to follow a western lead.” The UN created a Human Rights Council in Geneva in 2006, but the new body has not only avoided criticism of the lack of civil or political freedoms in Muslim countries, but also passed a resolution backed by the Organisation of the Islamic Conference and opposed by the EU which condoned limits to free speech on religious matters. Nor has the council criticised Russia and China, which jointly prevented it from scrutinising Belarus in 2006.

The main institutions of global governance, such as the UN Security Council, the G8 and the IMF, are steadily losing legitimacy and

<sup>1</sup> Kishore Mahbubani, *The new Asian hemisphere*, Public Affairs, 2008. authority because of the under-representation of new powers and the developing world within them.<sup>1</sup> They are also losing their

effectiveness: in Africa, for example, China’s ‘no-strings-attached’ loans have undermined the efforts of international financial institutions (and western governments) to improve governance through making aid conditional.

### Which kind of multipolar system?

Although the trend towards multipolarity is clear, the nature of the multipolar system that will emerge is not. Two kinds of multipolarity seem plausible: one competitive, the other co-operative; one based on the assertion of national power, the other on multilateral rules and organisations.

The leading countries, or poles, could line up in two competing camps, driven by ideology or some other set of interests, as happened during the Cold War. For example Robert Kagan, the American author, believes that the underlying political values of the

various poles will determine whom their best friends are. If his analysis is correct, Russia and China could form an ‘axis of autocracies’, united by their dislike of western political liberalism. They would face an axis of democracies, consisting of the US, Europe, Japan and possibly India.<sup>2</sup>

<sup>2</sup> Robert Kagan, *End of dreams, return of history*, Hoover Institution, Policy Review, August-September 2007.

Most Europeans think that that kind of balance-of-power politics would create undesirable rifts in the emerging multipolar world. They believe that the major challenges of the 21<sup>st</sup> century – such as climate change, energy security, migration and terrorism – require co-operation among all the leading powers, rather than just some of them. Europeans want to see a multilateral model of multipolarity: there could be shifting coalitions among the poles – and the democratic ones would have a natural affinity to work together – but all would take part in multilateral institutions and treaties, and respect international law. As the 2003 EU Security Strategy put it: “In a world of global threats, global markets and global media, our security and prosperity increasingly depend on an effective multilateral system. The development of a stronger international society, well-functioning international institutions and a rule-based international order is our objective.”

Of the major powers, the EU will always be the biggest champion of multilateralism – the concept is engrained into the DNA of its politicians, since the EU itself is a multilateral construction. China, Russia, the US and India, by contrast, can easily switch between unilateral, bilateral and multilateral behaviour, depending on their perception of which tool best promotes their self-interest.

There are good reasons to think that the new international system will be predominantly multilateral. As America’s power becomes relatively weaker, the argument in favour of it acting multilaterally, rather than unilaterally, will grow stronger. If the US becomes concerned about the behaviour of other powers, it is more likely to see the case for building strong international institutions to constrain

them. As John Ikenberry, a professor at Princeton University, puts it: “US dominance will eventually end. US grand strategy, accordingly,

<sup>3</sup> John Ikenberry, *The rise of China and the future of the West*, *Foreign Affairs*, January/February 2008. should be driven by one key question: what kind of international order would the US like to see in place when it is less powerful?”<sup>3</sup>

Moreover, the world’s democratic powers may not want to form an alliance against Russia and China. Many Europeans and Americans are convinced that engagement is preferable to confrontation. And western business interests will also push for open and amicable relations with the booming emerging markets. Nor is it likely that India, though a democracy, would want to take part in a strategy of containing Russia and China.

And would those two authoritarian states wish to form an axis? Their governments currently have a good relationship, and share a common distaste for the ‘colour revolutions’ that have spread liberal democracy to some of their neighbours. But Russia and China are

<sup>4</sup> Bobo Lo, *Axis of convenience: Moscow, Beijing and the new geopolitics*, *Chatham House and the Brookings Institution*, forthcoming, autumn 2008. not natural allies, and there is not much trust between their political elites. Moscow knows that in any close partnership with Beijing, China’s economic strength is likely to make it the leading partner. Many Russians fear growing Chinese influence in the far east of their country and in Central Asia.<sup>4</sup>

Furthermore, these two powers have very different views on how to deal with the West. During Putin’s second term as president, the Russian leadership often seemed paranoid about the West’s intentions, and it sometimes chose to deal with both Europeans and Americans in a truculent and confrontational manner. The leadership of the Chinese Communist Party, by contrast, has a strong interest in avoiding rows with the US, while it focuses on building China’s economic strength. China’s leaders care about how the rest of the world views their country, and hope that the Olympic games will highlight its emergence as a modern and dynamic world

power. They can become prickly when faced with foreign criticism that they consider unfair, as happened after the March 2008 protests in Tibet. Nevertheless, they want China to be accepted as a responsible power, so they sometimes listen to what the West says. And because China’s economy depends on exports of manufactured goods, it has a particular interest in an open international economy with strong rules. An energy exporter such as Russia feels less need for effective global economic governance: there will always be demand for its oil and gas.

For these reasons, the prospect of a China-Russia alliance against the West does not, at present, seem likely. Yet it is far from certain that multilateralism will triumph. The next few years will determine whether the world moves towards competitive or co-operative multipolarity, or some combination of the two. China’s own strategy and behaviour will be critical: it is a swing power that will tilt the international system one way or the other.

The single most important geostrategic relationship of the 21<sup>st</sup> century is likely to be that of China and the US, because of their economic power and potential strategic rivalry. But the China-EU relationship will also be crucial. If China and the EU manage to build a friendly and fruitful strategic partnership, they can do a lot to bring about a multilateral world. But if their relations became frosty and fraught, the scenario of competing ideological blocs will become more plausible.

When World Bank President Bob Zoellick was Deputy Secretary of State, he said that the West’s main objective towards China should be to turn it into a “responsible global stakeholder”.<sup>5</sup> However, America’s own tendency towards unilateralism, particularly evident during the first term of President George W Bush, weakens its credibility when it asks China to respect international organisations and rules. The EU is much better placed to do so, not only because of its track record of supporting

<sup>5</sup> *Speech to the National Committee on US-China relations*, September 21<sup>st</sup> 2005.

multilateralism, but also because – in contrast to the US – it is not a geopolitical rival of China.

Most European governments hope that China will play a bigger role in global governance, while the Chinese leadership wants to see a stronger EU. “The EU helps to achieve a balance in the multipolar world, and we would like it to play a more active and constructive role on the world stage,” says Zhang Zhijun, vice minister in the international directorate of the Chinese Communist Party. “We don’t have conflicting interests and we don’t threaten each other. We have complementary trade and economic relations.”

Despite the obvious differences between China and the EU – only the former is a state, and only the latter is governed according to liberal democratic principles – they are both regional powers intent on developing a political clout that matches their economic weight. The EU has begun to develop external policies that extend far beyond its corner of the world – ranging from the diplomacy that aims to end Iran’s enrichment of uranium, to military missions in Chad and Congo, to leading the international efforts to construct a system for limiting carbon emissions after the expiry of the Kyoto protocol.

Driven by its focus on economic growth, and the need to find the resources to fuel that growth, China has become increasingly active not only in its own neighbourhood but also much further afield. China is spreading its influence and investments across Africa. It has built increasingly close ties with several Latin American governments. It is also becoming a key player in most of the big questions of global security, such as the nuclear programmes of Iran and North Korea and the political crises in Burma and Sudan. China and the EU are bumping up against each other in more and more parts of the world.

### **Obstacles to a closer partnership**

China and the EU would benefit from a closer, more strategic partnership that would make it easier for their leaders to discuss

common interests and overcome disputes. For the Europeans, such a partnership should also aim to integrate China more fully into multilateral global governance. Yet the construction of such a partnership – which we attempt to define in the next chapter – will be far from easy. There are at least four potential difficulties.

One problem is the EU’s ability to manage a strategic partnership. Can the EU and its member-states learn to work together and to think strategically? Can they build the institutions that will enable them to deal effectively with other parts of the world? European foreign policy has had its successes: the EU speaks with a common voice on Iran, and most of the time – though not on the recognition of Kosovo – it has had a common position on the Balkans. But the persistent desire of the larger member-states to run their own bilateral relationships with Russia and China, rather than to work through the EU, has enabled those powers to divide and rule. The EU needs to change in many ways before it becomes a more influential global actor.<sup>6</sup> In Chapter 2 we look at how the EU handles its relations with China.

<sup>6</sup> Charles Grant with Tomas Valasek, ‘Preparing for the multipolar world: European foreign and security policy in 2020’, CER essay, December 2007.

A second potential obstacle to a more constructive EU-China partnership stems from the US’s relations with both the EU and China. If relations between Washington and Beijing were to hit a stormy period, EU-China ties would suffer: many Europeans will always want to show solidarity with the US, as they did over the invasion of Iraq. China’s leaders worry about the US’s ability to sway EU policy, as it did during the 2004-05 row over the EU’s arms embargo on China (see Chapter 4). For the Chinese, the more the US affects EU decision-making, the less interesting the EU becomes as a potential strategic partner. Since the arms embargo row, Chinese leaders seem to have accepted that the EU is not going to take an anti-American line, and they have re-emphasised their bilateral relations with EU states. But they still think it is in China’s interest to cultivate close ties to the EU per se, and they know that on some

issues, some of the time, the Europeans will have different views from the Americans.

A third set of obstacles is the growing economic tension between the EU and China. The EU's trade deficit with China reached \$235 billion in 2007, only slightly smaller than the US-China deficit, and Chinese exports to the EU are growing much faster than to the US. Many European politicians and voters now think that China does not play fair, and that the EU therefore needs to take a tougher stance towards it. Some of the EU's complaints concern Chinese exports – allegedly dumped at unfair prices, manufactured with stolen intellectual property, or made in ways that endanger the consumer. European business is growing increasingly concerned about the various obstacles to selling into, and investing in, the Chinese market. The under-valuation of the renminbi (RMB) is also becoming a contentious issue between the EU and China. For their part, Chinese officials complain that the EU is becoming more protectionist against Chinese goods and investments (see Chapter 3).

So far, neither China nor the EU has shown much willingness to be flexible over these commercial disputes. As the global downturn starts to bite, calls for protectionism and retaliation on both sides are likely to grow louder. Economic arguments have the potential to disrupt the broader relationship because, in their essence, they are about much more than trade and investment. They have implications for the legitimacy of the Chinese regime, and for the EU's own search for a new rationale.

<sup>7</sup> As a proportion of GDP, China's combined imports and exports of goods and services come to about 75 per cent; the figures for the US and the EU (excluding intra-EU trade) are about 25 per cent.

China's leaders believe that a large part of their legitimacy depends on economic growth. To continue growing, China depends much more on trade than any other big economy.<sup>7</sup> The country's leaders are aware that their export-driven and industry-focused growth model is causing domestic problems, such as rising inflation and misallocations of investment. That is why they now

preach the need for a “harmonious society”. But they are very reluctant to tamper with a growth model that for decades has delivered rising living standards and social peace. And because they still view their country as poor and developing, they are unabashed about simultaneously demanding that China be allowed to protect its industries while others be made to open their markets.

The EU's leaders have their own sort of legitimacy problem, which is spurring them to take a tough line on China. Most European citizens take peace, stability and the single market for granted, and give the EU little credit for those benefits. Many of them actively dislike the Union, seeing it as a Trojan horse for the forces of globalisation. France's president, Nicolas Sarkozy, has urged the EU to protect Europeans from the harsher side of globalisation, and to help them adjust to it. Many other European leaders would agree with Sarkozy that this should be a new rationale for the EU. Some Commission officials admit that they think they have to get tough on China, lest the French and the Germans judge their institution to be naïve and irrelevant.

There is a real danger that these economic arguments will become strategic, in the sense that they will stunt the development of what could become a much broader and more fruitful political relationship. If European and Chinese leaders fail to reach amicable agreements on issues like steel prices, counterfeit goods and exchange rate policies, and if each side blames the other for a downward spiral of protectionism, they will be much less likely to work together constructively on long-term political challenges. More broadly, a serious chill between the EU and China would diminish the prospect of China engaging with and helping to shape global multilateral institutions. Therefore a major task for leaders on both sides is to manage the economic links and tensions in ways that do not harm the developing political relationship.

A fourth potential obstacle is that China could evolve in ways that make Europeans recoil from the prospect of a closer partnership.

Until recently, most Europeans took a broadly positive view of China's development. But some things happening inside the country give Europeans pause for thought.

The government's suppression of the disturbances in Tibet in March 2008 led to anti-China protests in many European countries. Some of the western reporting of the clashes in Tibet was, as Chinese leaders said, simplistic and biased. But the hard-line language used by those leaders – about both the protests in the rest of the world, and the Dalai Lama himself – tarnished China's image. The international media's presence in China during the Olympic games is bound to put the spotlight on issues that Europeans care about, such as environmental degradation and arrests of dissidents.

Europeans also worry about China's foreign policy. Its growing engagement in Africa, Central Asia and the Middle East is mainly driven by its need for raw materials. But this engagement also helps to sustain a number of regimes that the West regards as pariahs. By 2007

<sup>8</sup> *Stephanie Klein-Ahlbrandt and Andrew Small, 'China's new dictatorship diplomacy', Foreign Affairs, January/February 2008.*

China had become the largest trading partner of Iran, North Korea and Sudan, and the second largest of Burma and Zimbabwe.<sup>8</sup> At certain times – as when Beijing praised Uzbek President Islam Karimov's suppression of demonstrators in Andijan in 2005 – China seems to be making

an ideological point, namely that autocracies should do what it takes to suppress the contagion of 'colour' revolutions.

China's reluctance to join international measures against Iran reduces the pressure on President Mahmoud Ahmedinejad's government to abandon its nuclear programme. Beijing's support for Sudan's rulers has enabled them to resist international efforts to make them restrain gangs of killers in Darfur. And when it comes to global governance, China is not always a responsible stakeholder. During the last round of United Nations reform, in 2005, China's opposition to Japan's membership of the UN Security Council (UNSC) was one reason for the collapse of the efforts to reform it.

Because of growing tensions over trade and investment, foreign policy and human rights, European public opinion has become more hostile to China. According to a Financial Times/Harris poll carried out in late March and early April 2008, China has replaced the US as "the biggest threat to global stability" in the eyes of Europeans. In Italy, 47 per cent thought China the biggest threat, up from 26 per cent in June 2007. In France, Germany and Britain, the figures were, respectively, 36 per cent, 35 per cent and 27 per cent (up from 22 per cent, 18 per cent and 16 per cent, last year).<sup>9</sup>

<sup>9</sup> *www.ft.com/harrispoll, April 15<sup>th</sup> 2008.*

### China debates its foreign policy

Some Chinese scholars of international relations emphasise that China should build up its power so that it emerges as the natural leader of Asia, and of global efforts to constrain US power. That kind of thinking leads some Europeans and Americans to worry that China could imitate the kind of unilateralist, assertive policies that George W Bush pursued in his first term of office. They fear that the stronger China becomes, the less it will see the point of acting through slow-moving international institutions, as opposed to unilaterally. When western analysts see defence budgets that consistently grow at a much faster rate than the economy, the cyber attacks that parts of China's defence establishment have launched against western governments,<sup>10</sup> or the testing of anti-satellite weapons in outer space, they worry that China could start to throw its weight around in the international system.

<sup>10</sup> *'China's cyber attacks: Casting a wider intelligence net', IISS Strategic Comments, September 2007.*

It is true that China – in contrast to the EU – has traditionally taken a realist view of international relations. It has been strongly attached to the Westphalian principles of national sovereignty and non-interference. It has taken a cautious approach to most international institutions, seeing them as western-dominated. But in recent decades many Chinese leaders have begun to talk positively about multilateralism as a concept, and China has joined

increasing numbers of international institutions, such as the World Trade Organisation.

For many Chinese leaders, officials and scholars, however, this taste for multilateralism is recently acquired and rather tentative. When they talk of multilateralism they sometimes mean multipolarity; or international co-operation in general; or the “democratisation of international relations” (code for the end of US hegemony); or their growing interest in regional bodies, such as the Shanghai Co-operation Organisation and ‘ASEAN plus three’, which they find more palatable than the global bodies dominated by the West.

Nevertheless, there is a genuine evolution in Chinese thinking on multilateralism, at least among some influential scholars and officials. One of these is Zheng Bijian, the inventor of the “peaceful rise” concept (the idea that China’s rise is benign and represents an opportunity not a threat to its neighbours). “We are for multilateralism as well as multipolarity. We need peace, markets and international co-operation to meet the three big challenges of the biological environment; the social environment; and resources and energy. We cannot achieve cultural rejuvenation just by reading Confucius, we need to draw on the experience of other countries. The West will have a significant influence on this civilisation.”

Not all the Chinese leadership would support that kind of liberal internationalism, but Zheng Bijian is not without influence,

<sup>11</sup> For an excellent analysis of these debates, see Mark Leonard, ‘What does China think?’, Harper Collins, 2008. having worked closely with President Hu Jintao as well as former President Deng Xiaoping. Within China, there is a wide-ranging debate over what kind of foreign policy it should adopt.<sup>11</sup>

China’s foreign policy today is somewhere between the extremes set by the liberal internationalists and the assertive nationalists – and probably rather closer to the former. Most EU governments do not believe that China will develop in a scary direction. They believe that

if Europeans engage China, they will increase the chances of it moving towards international co-operation and multilateralism. This report argues that Europeans have good reasons to be optimistic about China’s future. In a host of areas, ranging from UN peacekeeping to Burma to North Korea, China is learning to be a more responsible stakeholder, though slowly. The chances of China evolving into an aggressive country, prone to unilateral behaviour, seem relatively small.

The second chapter analyses the current state of China-EU relations. The third looks at the growing economic tensions between them, and their common interest in an open international trading system. The fourth considers the impact of US policy on the EU-China relationship. And the last chapter makes the case for a new kind of strategic partnership, focused on climate change, Africa and non-proliferation. In those three areas, as with the need to maintain open global markets, Europe’s dialogue with China should focus on working through, and strengthening, multilateral institutions.

## 2 A partnership that is not strategic

The current partnership between the EU and China cannot be described as strategic. They have a dense political relationship, including dialogues on subjects that range from human rights to science, migration and monetary policy. A ‘trade and economic co-operation agreement’ of 1985 sets the framework for the relationship. A new ‘partnership and co-operation agreement’, on which talks began in 2007, is due to replace it. Since 1998 there have been annual China-EU summits, and since 2005, annual ‘strategic dialogues’ at vice foreign minister level. And in April 2008, in Beijing, the European Commission and the Chinese government unveiled a new ‘high-level mechanism’ to discuss economic and trade issues.

But all these meetings do not add up to the “comprehensive strategic partnership” that the two sides committed themselves to in 2003. In May 2004, Chinese prime minister, Wen Jiabao explained (during a lecture in Brussels) what he thought a strategic partnership meant:

‘Strategic’ means that the co-operation should be long-term and stable, bearing on the larger picture of China-EU relations. It transcends the differences in ideology and social systems and is not subjected to the impact of individual events that occur from time to time. ‘Partnership’ means that the co-operation should be equal, mutually beneficial and win-win. The two sides should base themselves on mutual respect and mutual trust, endeavour to expand converging interests and seek common ground on the major issues while shelving differences on the minor ones.

Wen's definition of partnership is a good one, and we agree that strategic should mean a focus on the long term, rather than the short term. We would add two further definitions of a strategic relationship: it should cover not only economics, but also high politics and questions of security; and it should focus on a smaller number of major priorities, rather than attempt to cover every subject under the sun.

Looked at this way, the EU's relationship with China is far from strategic. First, it has tended to focus on the short term, dealing with questions such as whether China should be classified as a market economy status, or whether the EU should place claims on the number of Chinese bras imported.

Second, the relationship has so far focused mainly on economics. Long-term economic trends evidently have strategic implications. China's remarkable economic rise has alerted the world to its importance, driven the country to look for raw materials in every continent, paid for the modernisation of its armed forces, and made China a threat to the global climate. And, as we argue in Chapter 3, economic disputes have the potential to spoil, or spill over into, political relations. Nevertheless, until the EU and China think more about their common interests, and potential disagreements, on questions of global security, their partnership cannot be called truly strategic.

Third, the EU's relationship with China is not focused. According to the Commission, there are now 27 separate sectoral agreements and dialogues, covering subjects like climate change, regional policy, maritime transport, tourism, space science, the EU's research and development programmes, the ITER nuclear fusion reactor, university links, social security reform and the convergence of product standards.

Those involved in the dialogues say that some of them make a difference. For example, the dialogue on car exhaust emission

standards led to China adopting EU rules in this area. Another dialogue links 17 Chinese universities and research institutions to EU universities. They discuss topics like budgets, exchanges of personnel and new curricula. A third example, for which China's Ministry of Labour is the EU's partner, is social security reform. China's employer-based system of welfare has broken down, and the government has been looking to European countries for inspiration, with Sweden's egalitarian system attracting particular attention. The EU also finances a plethora of capacity-building projects in China, such as the China-Europe International Business School in Shanghai, and the China-Europe Law School in Beijing.

In addition to the EU's dialogues and projects in China, individual member-states have their own schemes and programmes in areas such as education, health-care, the environment, media reform and poverty reduction. The US also supports these kinds of project. But the European states do rather more than the US to train Chinese people outside their own country. In 2008 there are about 170,000 Chinese students in Europe, compared with 67,000 in the US. European countries train People's Liberation Army (PLA) officers in their staff colleges, and design special training courses for Chinese Communist Party (CCP) cadres, lawyers, judges and prison officers. The US provides much less training for those kinds of people.<sup>12</sup>

<sup>12</sup> David Shambaugh, 'Seeing the big picture in American and European relations with China: Past, present and future', forthcoming in Shambaugh and Gudrun Wacker (eds), 'Transatlantic policies towards China: Deepening the partnership', *Stiftung Wissenschaft und Politik*, 2008.

"The EU-China relationship is much broader and deeper than the US-China relationship," says Zhou Hong, head of the Europe Institute at the Chinese Academy of Social Sciences. The top politicians may not be aware of the 27 dialogues, "but the experts involved in these various fields understand the true nature of the relationship. What matters are not words but deeds. This kind of dialogue changes real life slowly and quietly."

But although some of the programmes and dialogues that link the EU and China undoubtedly add value, they do not amount to a strategic partnership. As proponents of a multipolar world, many Chinese leaders believe that China would benefit from an EU that was a more effective strategic actor (of course, that does not prevent them – like the Americans and the Russians – from exploiting European divisions for their own advantage). Similarly, many European leaders are happy to talk about the desirability of a more strategic relationship with China. But such a relationship would require the Europeans to learn to speak and act together when they deal with China, which they currently find very hard to do.

### Divided Europe

Both the EU and the Chinese government are organised in ways that make it hard for either side to treat the relationship as strategic. The EU is an organisation that does not easily think strategically about foreign policy. The Commission is responsible for the EU's trade policy and the overall economic relationship with China. In 2006, 19 of the 27 commissioners found a reason to visit China. But no commissioner has had overall charge of the relationship, and the various commissioners and their officials have not always co-ordinated their trips or shared information. In 2008 Commission President José Manuel Barroso made an effort to ensure a more integrated approach, and in April he led a group of nine commissioners to Beijing.

The lack of co-ordination between the Commission and the Council of Ministers – responsible for the political side of the EU's external relations – is another problem. The Commission officials negotiating with China on a partnership and co-operation agreement are aware that the Chinese are unlikely to sign it without the EU lifting its arms embargo. But the arms embargo is a matter for the officials working under High Representative Javier Solana in the Council of Ministers, and the two groups of officials, apparently, have had little contact. “If there is ever a case for having a single EU ‘foreign minister’, to replace the jobs now done by Solana and Benita Ferrero-Waldner

[the commissioner for external relations], it is the way the EU handles China”, says one senior Commission official.

The Council, just like the Commission, has problems handling China. In recent years, Solana has lacked senior officials with expertise on China. A bigger problem is that the 27 member-states have found it hard to agree on a common line – despite the fact that they share very similar interests in China. They all want it to run an economy that is open to trade and investment; to get serious about curbing carbon emissions; to respect human rights; to move towards a more pluralistic political system; to maintain friendly relations with its neighbours; to act cautiously on Taiwan; and to engage in dialogue with the Dalai Lama.

On some issues, the EU has a clear and unified position, such as (for now) to maintain the arms embargo, and to ask China to ratify the International Covenant on Civil and Political Rights. Trade commissioner Peter Mandelson speaks for the Union on many commercial issues, since external trade is an EU competence – although the national capitals argue furiously over what Mandelson's mandate should be. But on several other important questions, such as how to respond to the tensions between China and Taiwan, or to the protests in Tibet, the Europeans have found it hard to forge common policies. And Solana can only speak for the EU when the 27 can agree on a single line.

One of the reasons for intra-EU divisions is that the member-states perceive themselves as having different short-term commercial interests in China. The southern and eastern members are particularly sensitive to imports from China, since they rely on industries – such as textiles and household appliances – where the Chinese compete directly. Germany, as the biggest EU exporter to China, and a big investor in manufacturing there, is keen to keep markets open and strengthen the protection of intellectual property rights. Britain's priority is to gain access for its financial and other services companies.

The EU countries also take varying degrees of interest in security questions and human rights. The larger ones give some thought to East Asian security, while many of the smaller ones care little about Taiwan, the Japan-China relationship or the North Korean nuclear problem. Some of the smaller countries in Northern Europe take a strong interest in human rights in China, as do formerly Communist countries such as Poland and the Czech Republic. But many other smaller states see China merely as a commercial opportunity. They are reluctant to support policies or statements – for instance on technology transfer, human rights or Taiwan – that could threaten business opportunities in China.

### **The rivalry between the big three**

The bigger states are themselves divided over how to handle China, sometimes because of differing approaches to transatlantic relations. Thus in 2004-05, when the French and German governments led the campaign to lift the EU arms embargo on China, the British were more susceptible to US pressure to postpone lifting it (see Chapter 4).

The arrival in office of Angela Merkel and Nicolas Sarkozy – both more Atlanticist than their predecessors – has helped to reduce intra-EU divisions. But the bigger states, and especially Britain, France and Germany ('the big three'), still see each other as commercial rivals in China. They believe they are important enough to have their own, significant bilateral relationships. So they are often reluctant to join forces with either the other big member-states or the EU institutions.

"We each seek to undermine the other member-states in the hope of short-term commercial advantage, access to the key decision-makers, and influence," says a diplomat working for a big EU country in Beijing. "The Chinese are skilled at playing us off against each other."

China exploits these divisions by rewarding what it considers as good behaviour and punishing those governments that do the 'wrong' thing. Usually the Chinese government does not go so far as

to deprive the offending government of commercial contracts. For example, when Britain led a group of member-states to block the lifting of the EU arms embargo in 2005, it did not appear to suffer commercially. But there is always that possibility. Thus in the late 1990s, Denmark's trade with China dipped perceptibly, after the Danish government supported a United Nations human rights resolution that criticised China. And in the early 1990s, after France had sold frigates to Taiwan, it lost many contracts and was banned from bidding for the construction of subway systems.

Any EU government that meets Taiwanese leaders formally rather than informally is liable to face punishment. And the same policy now seems to apply to the Dalai Lama. In October 2007, Angela Merkel met the Dalai Lama in the chancellery in Berlin. As a result, Beijing delayed (but did not scrap) contracts due to be signed with Germany, and it cancelled a series of meetings with the German government. None of Germany's partners expressed much solidarity with Merkel. And in the German government it is widely believed that, within a few days of Merkel meeting the Tibetan leader, President Sarkozy had called the Chinese leadership to suggest that France could become China's chief partner in Europe.

The big three are reluctant to work through the EU not only because they see each other as rivals, but also because they do not always take the EU seriously as a foreign policy actor. For example, senior officials of the EU and China meet regularly to discuss subjects such as Africa, energy, human rights, illegal immigration and strategic issues. But the British, French and Germans insist on having their own strategic dialogues with China, while the British and the French have their own, separate, Africa dialogues. When we asked an official from the UK Department of International Development why the British needed their own Africa dialogue with China, she replied: "Because we don't trust the EU, it doesn't have the expertise." Similarly, the British and the French have their own dialogues with China on energy, human rights, Taiwan and

North Korea. From the Chinese point of view, all these multiple dialogues can be an annoyance, taking up the valuable time of senior officials and vice ministers.

We do not argue that the big three should downgrade their bilateral relationships with China. Given the importance of the country, it would be unrealistic to expect them or other EU governments to hand over their relations with China to a series of Brussels-Beijing dialogues. In any case, the Chinese value personal contacts with particular leaders from European countries. Javier Solana, the EU's High Representative, has decided that China should not be his top priority; he has probably been right to focus on the Balkans, the Middle East and Africa, given his limited resources and the difference that he can make in those regions. Commission President Barroso does not have much of a role to play on the non-economic aspects of foreign policy. So visits to China by senior politicians from the member-states can be good for the EU as a whole.

<sup>13</sup> Mark Leonard and Nicu Popescu call this 'principled bilateralism', in the context of EU-Russia relations. See their 'A power audit of EU-Russia relations', *European Council on Foreign Relations*, November 2007.

We do argue that the member-states' bilateral contacts should reinforce rather than undermine EU objectives.<sup>13</sup> When they are pursuing similar interests in China, they would often achieve more by working together, or with EU institutions. Take the EU's reaction to the conflict in Tibet and the consequent

demonstrations in Britain and France against the passage of the Olympic flame. Bernard Kouchner, France's foreign minister, urged the EU to aim for a common position. But Sarkozy unilaterally announced that he was thinking of boycotting the Olympic games opening ceremony. Britain's prime minister, Gordon Brown, unilaterally said that he would attend the closing, but not the opening ceremony. Merkel unilaterally stated that she would not attend the games.

We doubt that such pronouncements will make much impact on Chinese policy. But if Britain, France and Germany – or, better still,

all 27 – had given the same message to China, it might, perhaps, have had some effect. In our view, they should have all said: "We want the Olympic games to be a success and we believe in engagement with China, so we will attend the games; but we also urge the Chinese authorities to enter into dialogue with the Dalai Lama, and to remove restrictions on journalists in Tibet." That was more or less the message of President Barroso when he visited Beijing in April 2008, and soon afterwards the Chinese government did resume a dialogue with some of the Dalai Lama's officials.

### Unreadable China

The Chinese find the EU, with its complex institutions, hard to deal with. The feeling is mutual. In some ways, the Chinese government is even harder to read than the Brussels bureaucracy. In the EU – despite its baroque institutional machinery – a keen observer can work out who is responsible for which decision. The Chinese system is much less transparent. European decision-makers often do not know who on the Chinese side is taking decisions. China's political structures are highly centralised, which means that the more sensitive issues are often referred up the hierarchy to near the top. This may lead to delays and frustration. For example, in the summer of 2007, the Chinese government would not agree to a date for the annual EU-China summit, which is held every autumn. In the end, a date was fixed just two months before the event, whereas the EU's other interlocutors are generally willing to commit to dates much longer in advance.

On a whole range of protocol issues, the Chinese are difficult, according to EU officials. For example, who will represent the Chinese side in a meeting, and what will be the format? The Chinese may not answer such questions until just before the event. European officials believe that the Chinese use these kinds of procedural issue to frustrate and sap the energies of their counterparts.

EU representatives sometimes find it hard to work out to whom they should be talking, and to get access to the right people. They

may meet the Chinese minister who would appear to be their opposite number, but that person may not have full authority over the matter under discussion. In addition to the various ministries, there are agencies and commissions, as well as party bodies, that wield much influence in the Chinese system. For example, in November 2006, Peter Mandelson went to Beijing when the EU was about to start a case against China in the WTO, because of what it considered to be excessive duties on imported car parts. Mandelson wanted to negotiate a way through the problem, and avoid the formal procedure. But nobody in Beijing would engage seriously. The Ministry of Commerce, his main interlocutor, does not lead on the car industry, while the National Development and Reform Commission, which does, seemed uninterested in a deal. So the EU opened a case in the WTO.

### **A new kind of EU-China relationship**

As we have argued, the EU-China relationship is currently far from strategic. Although the two sides discuss pressing problems around the world, they do not engage in an organised dialogue that sets priorities and focuses on the long term.

But we think that the relationship is likely to become more strategic, for three reasons. First, the EU is slowly becoming a more coherent actor in the field of foreign policy. The Treaty of Lisbon, if ratified, will give the EU new foreign policy institutions. The revamped 'High Representative' will be a single spokesman for the EU, replacing the three roles currently performed by Javier Solana in the Council of Ministers, Benita Ferrero-Waldner in the Commission, and the foreign minister of the rotating EU presidency. The High Representative will be supported by a new European External Action Service. The new president of the European Council will also play a role in foreign policy. These institutions will take time to become effective. But in the long run, when the EU governments have a common position, the Union should be able to represent that position more effectively. In

particular, it should be able to make a better job of linking its economic and political priorities.

Second, China wants its relationship with the EU to become more strategic. China's leaders believe that a multipolar world is both a description of the reality that is emerging in the 21<sup>st</sup> century, and desirable. The more poles there are, the less the US will be able to dominate global politics and economics. They consider the EU a promising emerging pole. China's leaders regret that many European governments are unwilling to oppose the US on key strategic questions, but they take a long view, believing that eventually the EU is likely to become a more confident and independent actor. China's leaders believe that a Europe-China dialogue on strategic issues will help the EU to develop its own autonomous view of the world.

Third, China is moving to the top of the agenda of European politicians. The Olympic games, the unrest in Tibet and the Sichuan earthquake have made many more Europeans take an interest in the country. Furthermore, many people who never thought much about China have become aware of its growing economic might, as well as the accompanying opportunities and problems, as we explain in the next chapter. And there is a growing realisation that China is a crucial factor in a series of strategic challenges that matter to Europeans. These include non-proliferation, and notably Iran; Africa, including the situation in Darfur; climate change and energy security; and the need to reform the institutions of global governance. On these four subjects, there are serious differences between the EU and China. But on all of them, there has been dialogue. As we explain in Chapter 5, we believe that these subjects should form the basis for a strategic partnership between the EU and China.

## The EU and human rights in China

Whenever the EU defines its objectives in China, it says that it wants to improve the protection of human rights in the country. Yet in reality the European governments think they cannot do a great deal to enhance political freedom inside China. Most of them, most of the time, do not make much fuss about the human rights situation, although the Nordic countries are often the most vocal.

The EU finds it easier to get tough on human rights with small countries that are not of great economic importance, such as Burma, Cuba or Uzbekistan. However, the Europeans' soft-spoken approach to human rights in China reflects more than a recognition of their inability to change its internal politics, or the desire to maximise commercial gains. Europeans are aware that, overall, China is a much freer society than it was 20 years ago. The growth of economic freedom, prosperity, consumer choice and travel – within China and abroad – is evident. The level of debate among Chinese intellectuals, over a wide range of issues that include some sensitive political and economic questions, is impressive and encouraging.

Volker Stanzel, a German diplomat, recalls that when he was stationed in Beijing in the 1990s, nobody in the government would talk about human rights. When he returned as ambassador from 2003 to 2007, top officials were very happy to debate human rights – many of which are now enshrined in the Chinese constitution.

However, over the past five years, the Chinese government has clamped down hard on some kinds of journalism and political activity, and on internet sites. According to the San Francisco-based Dui Hua Foundation, using figures provided by China's Procurator-General, the number of those prosecuted for 'endangering state security' has risen steadily – from 249 in 2005, to 561 in 2006, to 619 in 2007.<sup>14</sup>

<sup>14</sup> [www.duihua.org](http://www.duihua.org).

In the human rights dialogues that the EU and several of its member-states run with China, the Europeans complain about general problems, and sometimes

highlight individual cases. In addition to the dialogues among officials, European leaders invariably bring up human rights when they meet their Chinese counterparts. The Chinese listen politely in all these meetings but seldom give the Europeans what they are asking for. A cynic would say that these meetings and dialogues allow the Europeans to let off steam over issues that trouble them, without spoiling the overall relationship.

However, some of those involved on the European side claim that the human rights dialogues deliver indirect benefits: they force Chinese officials from diverse departments to meet and discuss how to respond to the Europeans. Although European requests for the release of particular prisoners are seldom granted, the individuals named tend to be treated with scrupulous correctness and are sometimes released sooner than they otherwise would be.

Arguments over human rights have the potential to cast a shadow over the EU-China relationship. The unrest in Tibet, followed by China's crackdown in that region, and then vociferous protests against the Chinese government in many western countries, created strains in the first half of 2008. By drawing thousands of extra journalists to China, the 2008 Olympic games are placing the Chinese system – with all its strengths and weaknesses – under intense scrutiny. EU leaders will now talk more about human rights when they meet their Chinese counterparts. At the same time, popular anger in China about the anti-Chinese protests in the West has fuelled nationalist sentiment. This in turn may weaken the hand of moderates, liberals and multilateralists within the Chinese system.

The way that the Chinese Communist Party reacts to protests around the time of the Olympics, in Tibet or elsewhere, will shape how a whole generation of westerners views the country. A heavy-handed response would be a public relations disaster for China – which is why some enemies of the CCP may try to provoke such a response. If the Chinese authorities clamped down brutally on demonstrations, public opinion at home would not allow European politicians – however cynical or commercially-focused many of them may be – to remain indifferent. EU-China relations would certainly suffer. EU leaders must urge the Chinese government to handle any such incidents, and the critical foreign press coverage they are likely to generate, with sensitivity.

We think the EU is right to engage with authoritarian states such as China, even if their human rights record is poor. Closer political ties should give European leaders more opportunities to argue the case for political reform,

and to speak up for particular dissidents. Furthermore, greater contact between western and Chinese institutions will probably help to spread notions such as the rule of law and independent judiciaries. The integration of countries such as China into the world economy should foster the growth of a western-orientated middle class that may one day demand greater accountability of power, property rights, and so on.

The EU institutions and member-states should make a priority of promoting the rule of law in China, as – to be fair – some of them already do. Some of their programmes on governance and the rule of law, such as those that train judges and prison officers, probably do more long-term good for human rights than the dialogues. Talking about the rule of law is less sensitive than raising human rights issues. Most senior CCP cadres know that their country's long-term development requires greater respect for the rule of law. Foreign investors would of course welcome progress in this area. And if the concept of the rule of law took hold within the country, the Chinese government might find it easier to accept notions of rule-based governance in international bodies.

We do not think the EU should make improvements on human rights a condition for engaging China. Nevertheless, the policies and actions of the Beijing authorities will have a big impact on the kind of partnership that European leaders will want to build. If the CCP started to reverse some of the personal freedoms that Chinese citizens have gained in recent years, or clamped down hard on dissent, European leaders would be reluctant to enter into a deeper strategic relationship. Conversely, if China's leaders allowed a steady relaxation of freedom of expression, many European politicians would feel much happier about building closer ties with China. The way that China's leaders handled the horrific Sichuan earthquake – tackling the crisis with energy and determination, welcoming international aid and encouraging reporting by foreign journalists – greatly impressed Europeans, and helped to create a positive image of China.

### 3 Economic tensions

The core of the EU-China relationship remains, for now, trade and investment. But in these areas – until recently seen mainly as mutually beneficial – trouble is brewing. Europeans complain that trade relations are becoming unbalanced, and perhaps even harmful. They blame the burgeoning bilateral deficit on China's protectionism, industrial policies and exchange-rate peg. They are calling for reciprocity and a level playing field. Some no longer see China's economic boom as a benign miracle, but as a threat to the world's climate, and as the epitome of the kind of cut-throat capitalism that Europe is proud to have moved beyond.

Increasingly, public opinion sees China's economic rise as a problem. As a result, politicians and parliamentarians across Europe are calling for trade barriers, to protect local industries and to force China to change its ways. Some countries are constructing defences against potential investment from state-controlled funds, with China at the forefront of their minds. Afraid of looking weak or irrelevant, the European Commission has toughened its tone.

Europe's increasingly aggressive stance risks poisoning the relationship with China, without achieving very much in terms of trade rebalancing. The EU can slap more anti-dumping duties on Chinese shoes and steel, and it can write new rules to prevent Chinese companies from buying certain European ones. But such actions are unlikely to make much impact on the trade balance or China's currency policy. Protectionist policies could make Europe look inconsistent and insincere in Chinese eyes, especially if they stemmed from sectoral lobbying rather than a broader strategy aimed at mutual openness. With nationalist sentiment in China

already on the rise, there is a risk of escalating tensions causing real economic damage.

The EU should avoid bilateral arm-twisting and instead use, wherever possible, international organisations such as the WTO and the IMF to address contentious issues. In its bilateral relationship with China, it should appeal to China's enlightened self-interest. The Chinese are acutely aware of the limits of their export- and industry-led growth model. The EU can offer aid and expertise to help China shift towards a more socially equitable and environmentally sustainable model.

### China's rise, Europe's response

China is rapidly evolving from an emerging market to an economic superpower. With GDP growth rates of around 10 per cent a year, China's economy doubles in size every seven years. Economists argue about the true size of Chinese output, but there is little doubt that China will soon be one of the world's top three economies, alongside the US and the EU.

So far, China's economic rise has been mostly good for the EU countries. The EU's trade with China has grown at astonishing rates for two decades. Since 2002 it has risen by almost 20 per cent a year, to over €300 billion in 2007. The EU is China's biggest trading partner, while for the Europeans, China is number two after the US. This booming trade relationship has been a major source of growth and profits for EU businesses. It has also been good for consumers. One study from the

<sup>15</sup> Cited by Peter Mandelson in a speech to Tsinghua University in Beijing, November 7<sup>th</sup> 2006.

Netherlands suggests that cheaper Chinese goods have saved the average European household around €300 a year.<sup>15</sup> With 1.3 billion consumers, it is not surprising that China has

become an increasingly important destination for European investment: in 2006, cumulative foreign direct investment (FDI) from EU countries reached €35 billion. The EU Chamber of Commerce in China now has 1,100 members, up from 50-odd in 2000.

### EU-25 trade with China (€ billion)

	2001	2002	2003	2004	2005	2006	2007
Imports	82	90	106	129	160	192	229
Exports	31	35	42	48	52	64	72
Balance	-51	-55	-65	-80	-109	-128	-157

Source: European Commission

However, many European businesses are becoming frustrated about the difficulties of competing in China, and protectionist sentiment is rising among industrial workers. During 2007, the EU's bilateral trade deficit with China became a sensitive political issue, as did Beijing's currency policy, its foreign investment strategy and the impact of its voracious demand on global prices for oil, food and other commodities. But why has this happened so recently, given that the EU's trade deficit with China has been growing fast since the 1990s, and the euro started strengthening against the RMB in 2005? While the US has had heated discussions about its 'unfair' trade relationship with China for many years, EU-China trade relations had not attracted much attention until recently. Several factors explain why Europeans are becoming more agitated.

### ★ Enlargement obscures globalisation

Until recently, EU enlargement obscured the impact of China's economic rise on Western Europe. The process of eastward enlargement has added some 50 million low-cost workers to the EU's deeply integrated single market. For West European companies this has provided great opportunities for exports and outsourcing, just when the integration of China and other emerging countries into the world economy was making global competition fiercer. Trade between the EU-15 and the accession countries grew exponentially

during the 1990s. Even in 2006, the eurozone countries sold more to Poland than to China (although China has become a much more important supplier since 2001). Similarly, West European companies have invested perhaps three times as much in the Central and East European countries as in China. These trade and investment flows have resulted in a new European division of labour, whereby the East European countries specialise in electronics, furniture, cars and other manufactured goods, while the West European ones move into higher value-added goods and services. Moreover, millions of East European workers have moved west in search of higher wages since the 1990s.

<sup>16</sup> *The China price is the idea that cheap Chinese competition can force American businesses to cut their own prices and costs relentlessly. Business Week, in a special report on China on December 6<sup>th</sup> 2004, declared that “the China price” were the “three scariest words in US industry”.*

So when Germans, Austrians or French people fretted over cheap imports, the outsourcing of their jobs or migrant labour, they usually pointed their fingers at Eastern Europe. While Americans worried about ‘the China price’,<sup>16</sup> Europeans were talking about the ‘Polish plumber’ as a symbol of low-wage competition. However, as wage costs in Central and Eastern Europe have continued to rise (as they should if the new members are

to catch up with West European income levels), Chinese textiles and electronics have started to replace those coming from the Czech Republic or Poland.

### ★ The rising trade deficit

Europe’s consumers have benefited massively from the availability of cheap Chinese consumer goods while its companies have enjoyed new opportunities in the fast-growing Chinese market. These benefits accrue irrespective of whether exports are bigger than imports, or vice versa. Nevertheless, many people still believe that trade is only good if their country runs a surplus and they fear that rising imports could cost them their job. Therefore, trade balances easily become a focal point of political attention.

Until a couple of years ago, the EU’s trade deficit with China was small compared with the American one. In 2003, for example, the EU’s deficit of €65 billion was half that of the US. Perhaps more importantly, the EU’s deficit with China was compensated by the big surpluses that the EU ran with other countries. In contrast, China’s trade with the Americans added to the huge overall US deficit.

In recent years, the total EU external deficit has been growing, although it remained a fairly modest €160-170 billion in both 2006 and 2007. Most of this rise was related to the growing deficit with China, which reached €157 billion in 2007. Every single EU country now runs a deficit with China.

However, at the same time that the EU’s trade balance with China has shown a widening deficit, its trade with some other emerging economies has moved into surplus. Asia’s overall share of EU imports has risen only a little over the last ten years (by 10 per cent, according to the Commission). The reason is that many Chinese exports have replaced goods that previously came from countries such as Japan, Korea and Taiwan. These countries now ship components to China, where they are assembled and then sold as finished goods to world markets. Indeed, many European (and American) companies have their products put together in China. In 2005 such ‘processing trade’ accounted for more than half of China’s exports (and about half the goods exported from China are from foreign-owned factories). This

shift of manufacturing from other Asian countries to China helps to explain why the EU’s overall trade deficit in medium-technology goods did not rise much between 1999 and 2006, despite China’s spectacular export growth in such sectors.<sup>17</sup>

<sup>17</sup> *Andreas Freytag, “That Chinese “juggernaut”:* *Should Europe really worry about its trade deficit with China?”, ECIPE policy brief, April 2008.*

However, such crucial facts are hardly ever mentioned in the increasingly shrill European debate about trade with China (and the same holds true for the debate in the US). Instead, more and

more Europeans are starting to look at the ‘made in China’ tag with mixed feelings. A series of scandals about product safety in 2007 did not help. These involved poisoned pet foods, contaminated toothpaste and potentially toxic children’s toys. As European consumers grew more alarmed, the European Commission issued a couple of stern warnings to Beijing. According to Meglena Kuneva, the consumer affairs commissioner, of the 1,600 notifications for unsafe products that the Commission received in 2007, half concerned China. That high proportion partly reflects the fact that China produces and exports so many consumer goods. The Chinese authorities claim that less than 1 per cent of China’s exports to the EU are being flagged up as potentially dangerous. But the Commission counters that since Europe imports half a billion euros worth of goods from China every day, even 1 per cent is not acceptable.

### ★ No level playing field

As the bilateral trade deficit grows, the Europeans are becoming increasingly concerned about a perceived lack of reciprocity. How come, EU officials now ask regularly, that we buy more from China than from any other country, yet we still sell more to the Swiss than to the Chinese? Their answer, implied or explicit, usually is: China does not play fair.

<sup>18</sup> *The average tariff in China is now below 10 per cent, and only three percentage points higher than the EU average, although China’s ‘peak’ tariffs on individual items can be considerably higher.*

China opened up its economy considerably in preparation for WTO accession, and in the years following its entry in 2001. It has cut most import tariffs.<sup>18</sup> China has also started to open up services markets such as banking, and brought many of its laws into line with WTO requirements.

However, China’s move towards economic openness has slowed noticeably since 2006, and there have been various setbacks and

reversals. Non-tariff barriers to trade make it hard for foreign exporters and investors to do business in China. These include unclear or arbitrary health and safety requirements; licensing and registration rules that discriminate against foreign companies; subsidies for Chinese companies through direct cash payments, cheap energy or soft loans; public tenders that are opaque and inaccessible for foreign bidders; and the widespread violation of intellectual property rights (IPR). Trade commissioner Peter Mandelson claims that non-tariff barriers and discriminatory rules cost European companies €55 million a day in lost business opportunities.

The EU Chamber of Commerce in Beijing reports a long list of complaints from its member companies about China’s bureaucracy, which can be obstructive and untransparent. Examples include the imposition of proprietary technical standards to replace western ones; the sudden announcement of new laws on taxation or foreign investment, without prior consultation or sufficient time for implementation; and the use of ‘impossible’ regulatory requirements in sectors that are, in theory, open to foreigners. The Chamber <sup>19</sup> *European Union Chamber of Commerce in China, ‘Position paper 2007/08’, September 2007.* concludes that although China is now an integral part of the world economy, “there is a long way to go before reaching a genuine level playing field, in terms of trade and foreign investment”.<sup>19</sup>

The widespread violation of intellectual property rights has long topped the list of European concerns. The US Trade Representative reports that 85-93 per cent of all copyrighted products sold in China are pirated. At an international car fair in Hannover in September 2007, Chinese companies presented models that looked almost identical to certain BMW and A-class Mercedes models. Chinese companies have not only faked French luxury handbags and copied German cars, but also stolen industrial designs for machinery and technology on a grand scale.

European companies are therefore increasingly reluctant to comply with Chinese demands – often attached to FDI projects – for technology transfers. IPR violations do not only affect European companies that want to sell in the Chinese market: 60-80 per cent of fake goods that European customs officials confiscate at EU borders are made in China.

Chinese officials say that they are grappling with these issues. However, Europeans (and Americans) are becoming less patient. Seven years after China joined the WTO, they are demanding that the country become more serious about implementing its membership obligations. The EU is now making ‘a level playing field’ a major issue in its economic relations with China. And perhaps China’s difficult business environment is one of the reasons why European investment in China fell in both 2006 and 2007.

#### ★ China moves up the value chain

It is not only the volume of Chinese goods that concerns the Europeans, but also the changing composition of Chinese exports. Many people still think of China as a country that exports vast quantities of cigarette lighters, toys and T-shirts. It does still produce those things. But the Chinese economy is moving from low-cost, labour-intensive manufacturing to goods that require more capital and technology. In 2006, almost half of Chinese exports consisted of machinery, equipment and cars. China still makes 70 per cent of the world’s toys and two-thirds of its shoes. But it also accounts for more than two-thirds of global production of microwave ovens and DVD players, half of all personal computers and more than a third of mobile telephones and televisions.

There are several reasons why China is unlikely to have a future as a producer of low-cost, labour-intensive goods. First, China itself is struggling to compete in global markets for clothes and other basic manufactured goods. Wages in Bangladesh, India, Indonesia and Vietnam are half or less of those in China. Even some parts of the EU

now look poorer than Beijing or Shanghai.<sup>20</sup> Second, China does not have an unlimited supply of under-utilised labour. Although 700-800 million Chinese still live in rural areas, only a small fraction of that number is thought to be ‘surplus’ labour that could easily relocate to cities and industrial areas (the government puts the number at 150 million, while some independent analysts suggest only 40-50 million). The remnants of a restrictive registration system and the lack of welfare in urban areas make it difficult for people to move.

<sup>20</sup> *On certain PPP calculations, three Chinese provinces (with 43 million people, producing 10 per cent of Chinese GDP) are richer than the five poorest EU members. Patrick Messerlin and Jinghui Want, ‘The EU trade policy towards China’, Sciences Po policy brief, February 2008.*

Five years ago, some companies in the booming coastal towns had already started to report shortages of qualified workers. So far, wage pressures appear to have been modest: Chinese manufacturing wages have been rising roughly in line with productivity growth. But the changing balance in the labour market will eventually allow many more workers to demand higher wages and better working conditions. Chinese companies will only be able to offer them – and stay profitable – if they move up the value chain.<sup>21</sup>

<sup>21</sup> *Georg Blume, ‘Vorwärts und nie vergessen: Chinas Arbeiter werden sich ihrer Rechte bewusst’, Die Zeit October 18<sup>th</sup> 2007; Andrew Watt, ‘The rise of China as an economic power: What impact on the EU economy and labour markets?’, Transfer, Winter 2006.*

So far, China has benefited little from its shift into more high-tech exports. Much of its export boom is based on processing trade. Perhaps only 15 per cent of the value of China’s electronics and IT exports is added in China. “On close inspection”, says Daniel Rosen, visiting fellow at the Peterson Institute for International Economics, “China’s high-tech exports turn out not to be so very high-tech – nor, indeed, very Chinese.” That is why the government has ambitious plans for innovation and R&D. More and more Chinese youngsters are studying engineering and science, many of them abroad. *The Economist* aptly describes China as “restless with technological ambition”.<sup>22</sup>

<sup>22</sup> *Simon Cox, ‘High-tech hopefuls: A special report on technology in India and China’, The Economist, November 10<sup>th</sup> 2007.*

Meanwhile, China's specialisation continues to shift into more sophisticated industrial goods, if not into cutting-edge technology. The country is investing an astonishing 45 per cent of its GDP every year. This investment – inefficient though it often is – has built up massive new production facilities. There is evidence that China is already producing more and more of the components for its electronics, chemicals and car production. If investment continues at its current pace, China will increasingly specialise in capital-intensive goods (such as cars, steel and machinery) rather than labour-intensive ones (such as textiles). While Chinese competition in low-cost manufacturing has mainly affected the EU's smaller or newer members, such as Portugal or Hungary, the move into capital-intensive industries will mean more pressure on industries that are the mainstay of the big eurozone countries.

#### ★ The RMB peg begins to hurt

Until recently, few Europeans were aware of the impact of China's currency policy on their competitiveness. For the US, the effect was clear and immediate. In 1994, the Chinese pegged the RMB to the dollar at a rate of 8.28, and left it there for the next 11 years. But a fast-growing, open economy such as China's usually has a rising exchange rate, not a stable one, as its price level catches up with more developed countries. Successive US Treasury Secretaries have pointed to the widening bilateral trade deficit, and China's ever-growing foreign exchange reserves, as evidence that the RMB peg undervalues the Chinese currency vis-à-vis the dollar, and thus makes Chinese goods unduly cheap in the American market. Some US congressmen have even been calling for an across-the-board tariff on Chinese imports unless Beijing allows the RMB to rise.

For the Europeans, it was the euro's rate against the dollar that mattered (and still matters) most. The fact that the currency of China – and in fact most Asian currencies – moved in line with the dollar was hidden from view. Nor was that particularly worrying, as long as the dollar (and the Asian currencies) were strong against the

euro, thus giving EU companies a natural cost advantage. However, from 2002 to 2007, the dollar fell by over 40 per cent against the euro, and it dragged the Asian currencies down with it. This means that European companies have been squeezed in the American and Asian markets simultaneously, while American and Asian producers have been gaining a price advantage. But it took most European politicians until 2007 to fully realise the significance of these currency movements.

In July 2005, the Chinese government announced that it would move from a pure dollar peg to a (vaguely defined) basket of currencies, while at the same time giving the RMB a little more room to move. In theory, this new regime should have benefited the Europeans by allowing the RMB to also rise against the euro. In practice, however, the Chinese authorities have allowed only limited upward movements of the RMB, and they seem to have continued to target only the RMB-dollar rate with their exchange rate interventions. As a result, the RMB rose by more than 10 per cent against the dollar between July 2005 and the end of 2007, and another 4 per cent in the first four months of 2008 alone. However, the RMB has continued falling against the euro, by 7 per cent in 2005-07, and another 4 per cent in the first four months of 2008, despite the EU's intensified 'currency diplomacy' (see below). The RMB's fall against the euro has compensated for its rise against the dollar, with the result that the RMB's 'effective' exchange rate (measured against all its major trading partners) has changed little since 2005.

#### Is China losing its EU friends?

Until recently, only a limited number of European economists, business people and officials gave much thought to the EU's trade ties with China. Now this relationship is moving up the political agenda, and fast. Many Europeans have come to see their country's economic ties with China as a threat rather than an opportunity. At the same time, the voices of those who call for openness in the EU's relations with China appear to be becoming fainter.

Those industries in the EU that directly compete with Chinese mass manufacturers – such as Italian textiles, German light bulbs or Czech consumer electronics – have occasionally lobbied for protection. But European retailers and those industries that rely on cheap Chinese inputs, such as cars, have been pulling in the other direction. At the political level, for every EU government that has called for more trade protection, there has usually been one that argued in favour of keeping the EU market open and not spoiling business opportunities in China. The Chinese could usually rely on Germany, the UK and the European Commission to argue the case for open markets. But that seems to be changing.

The British may be instinctive free traders. But British business is unlikely to lobby a great deal on China's behalf. UK companies still sell roughly as much to Denmark or Dubai as to China. On the other hand, China is now Britain's fifth most important source of imports, with the result that the bilateral trade deficit reached €24 billion in 2006, a third of the UK's total trade deficit with non-EU countries. One possible explanation is the British economy's specialisation in services – which account for a third of British exports. Since China's banking, construction, consultancy and telecom sectors are difficult to penetrate, British firms are not making much headway in them. While the British people are still more sanguine about Chinese competition than most other Europeans, British business leaders are distinctly less enthusiastic about China

<sup>23</sup> Adrian Cooper, 'Why doesn't the UK export more to China?', *China-Britain Business Council*, 2007.

than their international peers. Globally, almost half of company bosses see China as the biggest opportunity for their business; in the UK the share is only 37 per cent.<sup>23</sup>

Perhaps most worrying for the Chinese is the shifting mood in Germany. Germany alone accounts for around 40 per cent of all EU exports to China, not least because its *Mittelstand* specialises in exactly the kind of machine tools that China needs to build up its industrial sector. Since 2000, Germany's exports to China have risen more than threefold. Because Germany is much more dependent on

exports than other big EU economies, it has traditionally worked to preserve free trade with China.

In recent years, however, the rising euro has made German goods more expensive outside the eurozone. The main reason why German exports continued to boom regardless is that German industrial wages have been flat or even falling in real terms. So Germany's continued export success has helped its companies but hurt some of its workers. As a result, German domestic demand has been too low and German workers have become more and more fearful of globalisation.

In 2008, as the euro continued to rise and global growth slowed, such concerns mounted. Germany's trade deficit with China has more than doubled since 2000. At €25 billion, it was Germany's biggest bilateral deficit in 2007 (although it paled into insignificance compared with Germany's overall trade surplus of almost €200 billion that year). The German perception that China is more of a competitor than a promising market will grow as its industry moves up-market. Chinese car output, for example, is growing by 40 per cent a year. Although vehicles made in China have a long way to go before they can compete with the likes of Volkswagen or BMW, the fact that China now produces more cars than Germany worries some Germans.

The European Commission also seems to be running out of patience. While Washington has been putting pressure on China to change its external economic policies for many years, the EU's official approach to doing business with China has traditionally emphasised co-operation rather than confrontation. The Commission insisted that it should address disagreements with Beijing through bilateral dialogues on, say, trade policy, competition, food safety or IPR.

However, since 2006, the Commission's rhetoric has become notably tougher and less conciliatory. EU negotiators complain of being "taken for a ride", as their Chinese counterparts offer belated promises to change things without delivering much in practice. More

importantly, the Commission is concerned not to become too far out of step with changing attitudes in the member-states. “We have been accused of being naïve [with regard to China]”, says one Commission official. Therefore, the Commission has taken a more pro-active (the Chinese would say aggressive) stance on the issues that most worry the Europeans: Chinese exports and protectionism in the Chinese market; the impact of the RMB’s peg to the dollar; and the spectre of China using its newly accumulated wealth to buy ‘strategic’ companies in Europe.

<sup>24</sup> *European Commission, ‘A policy paper on EU-China trade and investment: Competition and partnership’, October 2006.*

The Commission signalled its new, tougher approach in October 2006, with a paper on trade and investment that shocked the Chinese.<sup>24</sup> This listed the EU’s grievances and warned that “there is a growing risk that the

EU-China trading relationship will not be seen as genuinely reciprocal. Political pressure in the EU to resist further openness to Chinese competition is likely to increase if these problems are not addressed.” The paper concluded that a key objective of the new partnership and co-operation agreement that the EU and China were about to start negotiating should be to remove obstacles to trade and investment, and to improve the protection of IPR.

In a private letter to Commission President Barroso in October 2007 (later leaked), trade commissioner Mandelson went further. He said that despite some Chinese efforts, market access for EU companies was not improving enough: “The development of China’s governance and its economy are simply out of sync. For example, they have relevant laws but not the enforcement capacity or structures to ensure product safety or protection of intellectual property rights. To some extent the Chinese juggernaut is out of control.”

Mandelson dismissed any move towards “systematic combativeness” as counter-productive. But he suggested that China could no longer expect to be treated leniently by claiming it was poor and underdeveloped. He suggested that the EU should treat

China as a normal country: then it could more easily use trade defences, or drag China in front of the WTO dispute settlement mechanism, if it failed to honour pledges on market opening, reducing red tape or protecting IPR.

### China: Economic threat or opportunity?

	Threat*	Opportunity**
France	70	26
Poland	67	18
Italy	66	28
Slovakia	65	22
Germany	53	43
UK	44	48
Europe***	59	34
US	59	33

\* “The Chinese economy represents a threat because low-cost Chinese products compete with our country’s products and our country’s companies can relocate to China.”

\*\* “The Chinese economy represents an opportunity because we can sell more of our country’s products in China, purchase low cost Chinese goods, and our country’s companies can invest in China.”

\*\*\* Weighted average of the six European countries included in the survey.

Source: German Marshall Fund, ‘Perspectives on trade and poverty reduction’, 2006; survey conducted among 1,000 random participants over 18 in selected countries.

Tough rhetoric in itself is unlikely to make China change its policies. But as one EU trade official observes, it signals to European businesses that the Commission is sympathetic to their concerns about Chinese competition. It could therefore encourage more companies to apply for protection in Brussels. And the Commission may be more likely to respond, since its move to take a tougher stance on China has coincided with its review of so-called trade defence instruments. These include tariffs to counter dumping, duties to compensate for state subsidies, and other temporary measures against 'unfair' trade. While some EU governments are pushing for the EU to keep the use of these mechanisms to a minimum, others view them as a legitimate defence against the painful consequences of globalisation. As a result, what should have been a rather technical exercise has become highly politicised: publication of the review was postponed in late 2007 and again (indefinitely) in January 2008.

What already seems clear is that the EU will follow the US in using more 'anti-subsidy' tariffs to keep out Chinese goods that are deemed artificially cheap because of improper state aid. So far the EU has used anti-subsidy tariffs only against countries that it classifies as a 'market economy' for trade policy purposes. But China – much to its annoyance – has not yet

<sup>25</sup> Usually, for anti-dumping tariffs to be WTO compatible, the EU needs to prove that the company in question sells goods abroad at a price that is lower than the cost of production. In non-market economies, prices are seen as so distorted that the EU can use reference prices from a third country, such as Taiwan or Brazil.

been awarded market economy status by the EU (nor have the US and India given China that status, although more than 60 countries, including Russia, have done so). The fact that the EU has not defined China as a market economy gives it more leeway in the use of anti-dumping duties against Chinese exports.<sup>25</sup> So China could end up with the worst of both worlds, facing more anti-dumping actions, as well as anti-subsidy tariffs normally reserved for developed economies.

Beijing officials say that it is the EU's own fault if its sclerotic (in their eyes) economy cannot compete with China. "China has been preparing for globalisation for the past 20 years, for example while we negotiated to join the WTO, but the EU was less ready for it," says Qin Gang, a foreign ministry official. He has a point on textiles. In January 2005 the Multi-Fibre Agreement expired, leading to a surge of Chinese imports. But although European governments had known since 1995 that the demise of the MFA would remove barriers to imports of Chinese clothing, some of them had done very little to prepare their industries. So they lobbied the Commission, which in June 2005 restricted the imports.

However, Chinese allegations that the Europeans are becoming protectionist are overblown, at least so far. China's exports to the EU are growing faster than those to any other major market. China now sells more to the EU than to the US, and it is Europe's single most important supplier of manufacturing imports. There have been occasional bouts of protectionism in the EU, such as the 'voluntary' export restraint on clothing that China and the EU signed in 2005; or the anti-dumping duties imposed on light bulbs in 2001, shoes in 2006, frozen strawberries in 2007 and steel in 2008. But 98-99 per cent of Chinese goods travelling to the EU have been unaffected by such trade defences. In fact China was until recently the biggest beneficiary of the 'generalised system of preferences' (GSP), under which the EU grants special market access to goods from developing countries. Although some of these preferences are being phased out, China still accounted for more than 10 per cent of all GSP imports into the EU in 2006, and EU governments have decided that China should keep some of these benefits until at least 2012.

For now, the EU seems to be sticking to its dialogue-based approach, while trying to make it more effective. In April 2008, Barroso took nine commissioners to Beijing to inaugurate a new 'high-level economic and trade dialogue mechanism'. This forum is expected to take place twice a year, to sort out problems in areas like market access, intellectual property, technology transfer, energy and the

environment. At the first meeting the Commission asked for the enforcement of IPR and also urged the Chinese to make it easier for foreigners to invest in the energy sector. Chinese ministers wanted progress on trade facilitation and on the transfer of new technology to China.

This dialogue is potentially good news for the Europeans. Until its inception the EU's official counterpart for trade-related grievances had been the Chinese Ministry of Commerce, which has relatively limited political clout. The new dialogue is led by vice-premier Wang Qishan on the Chinese side, and Mandelson on the Commission side. The Europeans were given the same treatment that the Americans had had during their 'strategic economic dialogue' (SED) with the Chinese, with the same level of minister, and even the same meeting room.<sup>26</sup>

<sup>26</sup> *The SED started in 2006 and is led on the US side by Treasury Secretary Hank Paulson. Wang Qishan now leads on the Chinese side.*

Among EU officials, there is cautious optimism about the new mechanism. They note that it took the US-China SED a year and a half to produce results. The Europeans hope that their own dialogue can deliver results more speedily. As one EU trade negotiator puts it: "We need a relationship based on straight talk and real compromise. Not tea and blah blah."

### Mr euro goes to Beijing

Whatever comes out of the new high-level mechanism, one shortcoming is already apparent. Unlike the US-China strategic economic dialogue, that between the EU and China will not address currency issues. The Commission cannot claim to speak on behalf of the 15 countries of the eurozone. That is why a trio of eurozone officials – Jean-Claude Trichet, the ECB's president, Jean-Claude Juncker, the Luxembourg prime minister and president of the Euro Group, and Joaquin Almunia, the commissioner for economic and monetary affairs – travelled to Beijing to make the case for more RMB flexibility in November 2007. After the meeting, the Chinese

central bank promised "comprehensive measures ... to avoid big swings in currency movements and make respective contributions to an orderly adjustment of global imbalances", and a working group of officials from the two central banks was established. However, as the RMB resumed its downward trend against the euro in 2008, the Europeans reserved their judgment on whether this first foray into an external euro exchange rate policy would prove a success.

The Chinese authorities usually react to pressure from the US or the EU to revalue the RMB by acknowledging the need for currency reform, but urging patience. They fear that a large and rapid rise of their currency would price Chinese exports out of world markets, thus strangling growth, endangering jobs and potentially undermining the legitimacy of the Communist Party.<sup>27</sup> They therefore insist that exchange rate policy will only change gradually, at a speed compatible with continued strong growth.

<sup>27</sup> *Yongnian Zheng, Jingtao Yi and Minjia Chen, 'Revaluation of the Chinese currency and its impact on China', China Policy Centre, University of Nottingham, October 2007.*

Meanwhile, however, the Chinese authorities are struggling to cope with the massive amounts of foreign currency that are flowing in because of the trade surplus, FDI and 'hot money' that is gambling on an RMB appreciation. If China had a flexible exchange rate, these inflows would rapidly push up the value of the RMB. Now they just add to the amount of money in the economy. In an effort to prevent this excess liquidity from boosting inflation, the Chinese authorities have been buying up the dollar inflows, thus adding \$2 billion a day to their foreign exchange reserves.<sup>28</sup> These reserves reached a mind-boggling \$1.68 trillion in March 2008.

<sup>28</sup> *Since 2007 the undervalued RMB has added to other price pressures, with the result that inflation reached a 12-year high in April 2008 of about 8.5 per cent. The Chinese authorities sought to contain inflation through stricter controls on bank lending and the postponement of energy price liberalisation. Such moves go against Chinese plans to make the economy more open.*

Most of this money is invested in US Treasury bills and other low-yielding assets. However, as the dollar lost value in 2007 and 2008,

and as American interest rates dropped, China suffered very substantial losses on its holdings of dollar assets. If China shifted its reserves into euros or other currencies, the dollar's fall would only accelerate, and China would lose even more money. Beijing has therefore decided to invest a part of its reserves into higher-yielding assets. This may be a sensible move from the Chinese point of view, but it has caused more anxiety in the West: many Europeans (and Americans) are not happy about the prospect of Chinese state-controlled vehicles buying local companies.

### Chinese overseas investment

Traditionally, the Beijing authorities frowned upon Chinese companies investing abroad. They preferred local firms to build joint ventures with western ones inside China, and concentrate on making things to export. But that changed in 2002, when the government encouraged local businesses to “go out” and invest abroad. Within the next five years, the stock of Chinese FDI abroad almost tripled (although from a very low base). While much Chinese money has gone into Africa and other resource-rich regions, Chinese companies are increasingly interested in shopping in western economies. They do so to find partners for penetrating key markets, acquire new technology and buy up well-known brands.

There have been a number of high-profile cases since 2002, for example TLC's acquisition of television makers in Germany (Schneider) and France (Thomson); Shanghai Automotive Corporation's take-over of the UK's Rover; and Lenovo's purchase of IBM's personal computer business in the US. Although some European and American politicians and trade union leaders expressed concern about the sale of industrial assets to the Chinese, most of these acquisitions proceeded more or less smoothly. However, some of China's planned investments in the US had to be abandoned, notably CNOOC's (China National Offshore Oil Corporation) bid for America's Unocal in 2005, and Huawei's attempted purchase of a stake in 3com, which makes routers and

networking equipment, in 2008. There has not yet been a similarly controversial case in Europe, but if a Chinese company sought to buy a big industrial firm, media business or bank, politicians would come under pressure to stop it.

The question of whether Chinese investment is welcome, and under what circumstances, gained new salience with the launch of the China Investment Corporation (CIC) in September 2007. The CIC is a state-controlled fund with a mission to invest a part of China's foreign exchange reserves in companies at home and abroad. The CIC's initial endowment is \$200 billion, of which around a third is available for investment abroad. This sum looks modest by global standards: analysts reckon that the total assets managed by sovereign wealth funds (SWFs) amounted to over \$3 trillion in early 2008, and that this sum could rise to as much as \$10-15 trillion by 2015 (although such projections are contentious). However, many expect that the CIC could soon become one of the biggest SWFs, larger even than the much older funds run by Middle Eastern oil producers. Nor is the CIC the only vehicle that China can use to invest its reserves abroad. In April 2008, it emerged that SAFE (China's State Administration of Foreign Exchange) had invested €1.8 billion in France's Total and £1 billion in the UK's BP.

Western businesses regard SWFs primarily as a welcome source of additional funding. Following the 2007 credit crunch, several of the world's largest banks sought re-financing from SWFs, with one, Morgan Stanley, taking \$5 billion from the CIC. However, many politicians and a growing number of voters in Europe and the US are nervous that such huge sums are being managed by funds linked to governments that are not unequivocal supporters of economic or political freedom. Even those who are relaxed about the potential political agendas of SWFs express concerns about the low standards of corporate governance and transparency of certain funds. Although some SWFs are managed professionally and at arm's length from the state, others have close institutional and personal links with authoritarian regimes. SAFE operates

under the authority of the Chinese central bank. And Lou Jiwei, who is in charge of the CIC, is a former finance minister who still acts as deputy secretary-general of the State Council (in effect, China's cabinet).

How should western countries react to the prospect of investment by state-controlled funds? The US has its 'inter-agency committee on foreign investment' (Cfius) to assess the national security implications of a proposed investment by a state-controlled foreign entity. In the EU, similar mechanisms are still rare. But some EU governments are talking about new defences, mainly with state-controlled entities from Russia and China in mind. France has a list of 'strategic' sectors in which foreign investment may be restricted for reasons of national security. In April 2008, the German government agreed on a draft law that will entitle a Cfius-like committee to block any foreign acquisition (by an SWF, a multinational or an investment fund from outside the EU) of more than 25 per cent in a German company, on grounds of endangering national security or public order. Not all EU countries are putting up defences: the British government has stressed that the UK, and in particular the City of London, is open to sovereign investors, including those from China.

The Commission is worried that national actions could damage the smooth functioning of the single market. So in February 2008 it unveiled a communication on SWFs which called on the EU member-states to keep their economies open while asking SWFs to comply with certain minimum standards of transparency and accountability. EU leaders endorsed the Commission document the following month, adding that the EU should continue to work on a voluntary code of conduct for SWFs that want to invest in Europe, while supporting similar efforts in wider international forums. For some EU governments, however, such voluntary guidelines may not be enough. Commission officials have already indicated that they will propose binding rules unless SWFs comply with a voluntary code.

### **Bilateral arm-twisting or multilateral co-operation?**

The global slowdown, combined with growing domestic demand within China, stopped the rise of China's external surplus in the first quarter of 2008. At the time of writing, it is not clear whether this was a temporary slowdown or the reversal of a trend. What is clear is that Europe and the US are affected differently. While Chinese sales to the US have slowed, those to the EU continue to rise. If the dollar's slide against the euro continues – dragging the RMB down with it – protectionist sentiment in the EU will keep growing. Then the quarrels between Brussels and Beijing would become more heated. The Europeans would complain about China's currency policy, its 'unfair' trade and industrial policies, its foreign investment strategy, and its disregard for the global environment. The Chinese would accuse the EU of being protectionist, of withholding market economy status for political reasons, and of double standards – for example, threatening to restrict Chinese investment while calling for Beijing to open its own markets. These days Beijing appears less willing to compromise. In the words of one commissioner: "In the past few years, Chinese leaders have become much more assertive in their dealings with the EU; nationalism has become the ideology of their party. So we in turn need to become stronger when we deal with China."

The EU's more confrontational stance may be justified – but only if it is part of a broad and consistent strategy that ultimately aims to keep both markets open, offers China help where appropriate, and encourages it to shoulder more responsibility for global economic governance (see Chapter 5). There is a risk that the EU's apparent willingness to resort to anti-dumping tariffs or trade defences may simply open the door to more protectionism in those sectors that find it hard to adjust to global competition.

If the EU did make serious moves towards trade protectionism, it would mainly hurt the Europeans themselves, by excluding cheap consumer goods and industrial components, limiting competition in the single market, damaging European firms that have invested in

China's export industries, and undermining the EU's credibility in international trade negotiations. The impact on overall trade balances would be questionable. Even if the EU decided to use all the available trade defence mechanisms, these could only ever affect a small fraction of the €200 billion worth of goods that the Europeans buy from China every year. Both China and the EU are WTO members and need to respect the organisation's rules. Although the rules that limit the use of defensive tariffs can be bent and stretched, the EU is unlikely to disregard them altogether. Thus while an anti-dumping action may bring temporary relief to clothing manufacturers or steel-makers, it cannot significantly dent the EU-China trade deficit. But it can send the wrong signal to the Chinese, namely that the EU's preaching about the importance of international rules and open markets is not backed by action.

The EU is right, however, to consider greater use of the WTO's dispute settlement mechanism. By joining the WTO, China has agreed to comply with its laws on trade and investment and to be bound by its rulings. Since 2001, the EU has brought only two cases against China in the WTO: one on excessive tariffs on imported car parts, which it won in February 2008, and one on restrictive practices by providers of financial information (the likes of Reuters, Dow Jones and Bloomberg are not allowed to sell their services in China), which started in March 2008. The US brought three cases in 2007 alone, it joined the EU in the financial information case in 2008, and it has threatened further action, for example over export tariffs and restrictions on credit card companies.

EU officials say that there have been dozens of prospective WTO cases – ranging from IPR violations to protectionism in services sectors – that they decided not to launch, so as not to antagonise the Chinese government. This, they say, is about to change. It is true that even a plethora of new cases might not make much immediate impact on EU-China trade relations. WTO cases usually take a year or two to get resolved. And in many cases the rulings are less than clear-cut, distributing blame among both parties. Ambiguous rulings

could make it easier for the Chinese to take modest steps to feign compliance. However, the Chinese government's aversion to litigation means that the mere threat of a new case may sometimes be enough to make it change its ways. For example, the Chinese reacted to one WTO case brought by the US by abolishing a host of contentious state subsidies. If the EU resorted to the WTO rather than bilateral arm-twisting – whatever the long-term impact on Chinese practices – it would be sending the right signal to the Chinese, namely that it will rely on multilateral institutions, rather than unilateral action, to resolve trade disputes.

As far as possible, the EU should use international organisations to deal with its concerns about China. It is laudable that the EU countries are trying to co-ordinate their responses to sovereign wealth funds. However, the EU needs to acknowledge that a viable response needs to involve not only the Arab, Asian and former Soviet countries that own the SWFs, but also all the major receiving countries, so that SWFs cannot play them off against each other. The IMF is busy on the former, working out a code of conduct with and for SWFs; and the OECD is working on guidelines for receiving countries. The EU has an important and constructive role to play in both forums.

On the currency issue, there is only so much that the EU and China can do bilaterally. Since China has accelerated the revaluation of the RMB against the dollar, the US has no strong reason to put pressure on the Chinese also to revalue against the euro (indeed, the Americans may fear that a rise of the RMB's 'effective' exchange rate could dampen Chinese growth at a time when the US is slipping into recession). But the chances of China revaluing against the euro as well as the dollar would be much greater if the US and the eurozone co-ordinated their messages. Moreover, China will be reluctant to change its exchange rate strategy unless the other Asian countries that peg to the dollar do so too. Therefore, the EU should encourage China to discuss currency issues in a wider format, perhaps in the IMF or in an enlarged G8 format.

If the EU shifted some of its discussions with China over trade, investment and exchange rate policies into broader international settings, it could address controversial issues without risking a bilateral showdown with the Chinese. This would also reinforce what should be a key purpose of any EU-China strategic partnership, namely to show that multilateralism works.

### Appeal to enlightened self-interest

In its bilateral dealings with China, the EU should try to frame its arguments in terms of China's own interests. They may find a sympathetic ear, because China's leaders are increasingly aware that the current imbalances within their economy are unsustainable. China's huge external surplus (11 per cent of GDP in 2007) is not only, or even primarily, an exchange rate issue. It stems from a much broader set of imbalances, in particular that between savings and investments, as well as an over-reliance on industry rather than

<sup>29</sup> *Wing Thye Woo, 'Dealing sensibly with the threat of disruption in trade with China', Brookings Institution, October 2007. See also the fascinating debate on Martin Wolf's online economists' forum: <http://blogs.ft.com/>.*

services, and on exports rather than domestic consumption; unusually high savings rates (especially in state-owned enterprises); an inefficient banking sector that cannot channel these savings into productive investments; and the lack of a country-wide social security system which makes Chinese workers save too much and spend too little.<sup>29</sup>

The downsides of this growth model are becoming increasingly obvious: inflationary pressures, asset bubbles, falling productivity, growing rural-urban income gaps, and environmental damage.<sup>30</sup> The Chinese leadership has already outlined numerous measures that it hopes will lead to an increasingly 'harmonious' development – one that relies more on domestic consumption, creates employment for those who want to escape rural poverty, provides basic social security, and slows the destruction of the environment. But the to-do

<sup>30</sup> *Jianwu He and Louis Kuijs, 'Rebalancing China – modelling a policy package', World Bank China Research Paper, September 2007.*

list is long and daunting, and the leadership worries that any slowdown in growth that stems from reform could undermine its legitimacy. In striking this delicate balance, the Chinese could benefit from some outside help and advice. The EU is already supporting China's reform processes, in areas ranging from banking to energy savings and social security. The Europeans should offer more such assistance, provided that the Chinese redouble their efforts to redress their internal and external economic imbalances. Such a dual-track approach, which could be described as 'talking tough but carrying a big carrot', would probably achieve more than a histrionic showdown over trade and the exchange rate.

## 4 China and transatlantic relations

Washington and Beijing currently have a fairly warm relationship. The Bush administration, like the Europeans, believes that the best way to handle China is to engage it. But the Americans worry much more than the Europeans about the possibility of China destabilising the security system in East Asia, to which the US, with several military bases in the region, is a big contributor. Most Europeans have tended to see China primarily as a market.

Although the Europeans are far from united on their China policy, their general attitude to Beijing has usually been softer than that of the Americans. This difference has the potential to disrupt not only transatlantic but also EU-China relations. The Chinese learned this in 2005 when pressure from Washington helped to prevent the EU from lifting its arms embargo on China. Transatlantic differences have the potential to cause more friction in the future.

Whereas Europeans are simply engagers, Americans combine their strategy of engagement with the idea of 'hedging'. Hedging could be defined as a softer, gentler form of containment. The strategy of containment – as applied to the USSR during the Cold War – involved working to undermine the regime; curbing economic links; and building alliances with countries around the rival, to prevent its power expanding. Hedging, as applied by the US to China today, means building alliances with other Asian countries, such as Australia, India and Japan. Such alliances are not designed specifically to oppose China, but could be useful in any future confrontation with it. Hedging also means restricting transfers of sensitive technology to China, and building military capabilities that are specifically focused on scenarios involving China. It does not mean restricting commerce or trying to overthrow the government.

Instead, the US engages with China through multiple channels, such as the strategic economic dialogue.

Despite the different approaches of Europeans and Americans, in the past few years there has been something of a transatlantic *rapprochement*. At the time of writing (May 2008), there are no serious EU-US disputes over how to handle China. Among the factors that have contributed to this alignment, at least three are notable:

- ★ The Bush administration, though never particularly hawkish on China, has become progressively softer during its time in office. There are still influential China hawks in the Washington think-tanks, and parts of the armed forces, who see China as a threat. But most senior figures in the administration pursue a policy of ‘engage and hedge’. And although plenty of politicians complain about China’s trade and currency policies, the predicted wave of protectionism against its perceived economic threat never arrived. During the presidential election campaign, protectionist sentiment has been targeted at the North American Free Trade Agreement, rather than China, although that may change as the US economy slows down.
- ★ The departures of Chancellor Gerhard Schröder and President Jacques Chirac (in 2005 and 2007 respectively) have changed the tone of Europe’s dealings with China. These two leaders avoided any kind of public criticism of China’s leadership, not only for commercial gain, but also because they (and particularly Chirac) shared its vision of a multipolar world that would limit America’s freedom of manoeuvre. Angela Merkel has criticised China on human rights policy, while Sarkozy is less effusive in his praise of the regime than his predecessor. Both are instinctive Atlanticists. And although Sarkozy has – rather quietly – said the EU arms embargo should be lifted, Merkel is firmly against doing so.

- ★ Both the EU and the US have learned lessons from the row over the lifting of the embargo (of which more below). A US-EU strategic dialogue on Asia, which involves senior officials meeting every six months, was established in May 2005. Both the row and this dialogue have helped Europeans to realise that the rise of Asia has implications for security as well as economics.

Europeans and Americans have very similar views on how they would like China to develop. That leads David Shambaugh, a professor at George Washington University, to argue that the EU and the US should run a dialogue on a whole plethora of issues, such as China’s role in non-proliferation, the renminbi, China’s development policy, the transparency of the PLA, disease and crime in China, computer hacking, human rights, regional security, Taiwan and climate change.

We would agree with much of that. The more that Americans and Europeans make an effort to understand each others’ approaches to China, the better the chances of a smooth transatlantic relationship. But we would distinguish between a transatlantic dialogue on these kinds of issue, and a concerted EU-US effort to shift Chinese policy. The latter is likely to cause much resentment in China, which is prone to become paranoid about the EU and the US ‘ganging up’ against it.

That said, there are a few issues on which it would make sense for the US and the EU to work together to influence China. Europeans and Americans would probably achieve more on trade and currency questions if they combined their efforts (as they have done on a few occasions). On some other issues, the Europeans might achieve more on their own. The fact that the EU is not the US gives it a certain credibility with many Chinese policy-makers. For example, on issues such as Taiwan or reform of the United Nations, the EU might achieve more on its own than as part of a joint EU-US *démarche*.

Despite the convergence of European and American views on China, important differences still remain. Two particular problems could create discord – the EU arms embargo, and the status of Taiwan. EU and US leaders need to manage these issues so that they do not damage transatlantic relations.

### The EU arms embargo could cause more friction

The European Council decided to impose an arms embargo on China shortly after the shooting of protesters in Tiananmen Square in 1989. This decision, which has no legal force, is of great symbolic importance to the Chinese. The embargo created major rifts between

<sup>31</sup> See Katinka Barysch with Charles Grant and Mark Leonard, 'Embracing the dragon: The EU's partnership with China', CER pamphlet, May 2005, pages 60-66.

the EU and China, between the EU and the US, and among Europeans, from 2003 to 2005, and may do so again. This is not the place for a detailed analysis of the arguments over the arms embargo, which can be found elsewhere.<sup>31</sup> But a few salient facts are worth recalling.

In 2003, China persuaded President Chirac and Chancellor Schröder to push for a lifting of the embargo. They agreed, wanting to forge a closer EU-China relationship and hoping for commercial benefits. By the end of 2004, Britain had come round to their position; it feared that if it continued to support the embargo, it could pay a commercial price in China. In December 2004, the EU announced that it would work towards lifting the embargo.

But the US then mounted a strong campaign in favour of maintaining it. Without the embargo, it claimed, China would stock up on sophisticated European weaponry. This was hyperbole: the EU planned to replace the embargo with a more stringent version of the 'code of conduct' that already applied to EU arms exports to the rest of the world. That code would be more effective than the embargo in blocking the export of advanced weaponry to China: after some debate, the Europeans agreed that it would be legally binding. But in Washington, and especially on Capitol Hill, the

opposition to the EU's plans became so fervent that threats were made against British companies active in the US. So the British withdrew their support for lifting the embargo, as did the new member-states from Central Europe. By April 2005, the EU as a whole had decided to postpone the lifting of the embargo.

Luckily for the EU, just when it was making its *volte face*, China passed the Taiwan anti-secession law, which implies that China will use force if the island declares independence. That law saved EU leaders much embarrassment, for it gave them an excuse to change their mind. Chinese leaders reacted to the EU's shift by becoming dismissive of the Union. More in sorrow than in anger, they said how much they regretted that the EU had not learned to think independently of the US, and that the EU still treated China as a pariah.

In this affair, all the principal parties behaved in ways that, with hindsight, seem ridiculous. France and Germany appeared unscrupulous in the way they supported lifting the embargo, and were unwise enough to ask for nothing in return, for example on human rights. Britain looked silly for reversing its policy. Many Americans exaggerated the potential impact of lifting the embargo and became over-emotional about it. And China weakened its position by passing the Taiwan anti-secession law at the wrong moment.

Ever since the spring of 2005, the EU has said that it will lift the embargo if and when it gets something in return, and it has specified that it wants China to ratify the International Covenant on Civil and Political Rights. If China did ratify that document (which it signed ten years ago) it might have to close its forced labour camps. Many European governments think that, in the long run, the embargo should go: the other countries to which the EU applies arms embargoes – Burma, Sudan and Zimbabwe – have much worse human rights records than China. But at the moment few of them are talking of lifting the embargo. It is unlikely that many member-states will want to do so unless and until the US-China relationship becomes much warmer.

Since 2005 the Chinese have not pushed strongly to remove the embargo, perhaps because they understand that the Europeans are not yet ready to do so. But China's leaders have not forgotten the issue and, when they think the time is right, will return to it. They may not accept a new partnership and co-operation agreement with the EU if the embargo is still in place. China might try to make it easier for the Europeans to lift it by offering something 'in return'. If the Europeans do make moves towards lifting the embargo, they will have to do a better job than last time of convincing the Americans to accept the change. They will have to show that a strong code of conduct, combined with procedures to limit the transfer of sensitive dual use technologies, will do more than the embargo to prevent China from acquiring advanced weaponry.

The Europeans are likely to press ahead with the new code, which would set stricter rules for arms sales to the whole world, rather than just China. In 2004 they talked to President Bush's officials about linking the code to a new EU-US procedure that would limit the transfer of the most sensitive technologies to China. But President Bush then decided to take a hard line in opposing the lifting of the EU embargo. Since the establishment of a new procedure on sensitive technologies would make it easier for the EU to lift, Bush told his officials to stop working on it. European leaders should approach the next US president with a view to reviving this idea.

But if the Europeans want the Americans to agree to this new procedure, they will need to show that they understand the strategic implications of technology transfers to China. Pentagon officials often complain that Europeans seem oblivious to the fact that if China acquires certain sorts of know-how it will affect the balance of power in Asia, for example across the Taiwan Strait. The Europeans will need to demonstrate not only a greater sense of strategic awareness, but also that their rules on technology transfer will be clear and effective.

### Taiwan: why Europe should care

Most European politicians think little and care less about Taiwan. Those Europeans who do think about international affairs are aware that the Taiwan Strait is a potential flashpoint. Most of them would back the EU line, which is to support a 'one China' policy (the principle that China and Taiwan are part of the same country), urge that cross-strait disputes be settled peacefully, and state that neither China nor Taiwan should disrupt the status quo.

The US line on Taiwan is similar, but the island matters much more to the Americans. They have been committed to the defence of Taiwan since the Taiwan Relations Act was passed in 1979. In 1996 the US sent two aircraft carriers to the area to remind Beijing of that point, after China fired missiles close to Taiwan. The links between the American and Taiwanese military establishments and defence industries are close. Being a smallish democracy that is close to a giant and well-armed authoritarian state, Taiwan attracts the sympathy of many Americans for similar reasons as Israel. When the EU said that it would lift the arms embargo, some Americans conjured up the image of US soldiers being blown up by French missiles on the beaches of Taiwan.

Taiwan's presidential election in March 2008 has, at least in the short term, lowered tensions across the Taiwan Strait. The victorious Kuomintang candidate, Ma Ying-jeou, favours a moderate *rapprochement* with China, while the defeated Democratic Progressive Party argued for a more independent line. But in the long run the question of Taiwan's status remains a potentially disruptive issue. Most Taiwanese favour the status quo, regarding it as de facto independence, but a minority would like to move towards de jure independence. There is a growing sense of Taiwanese identity on the island. Meanwhile on the mainland, when CCP leaders threaten to meet any move towards independence with force, they know that most Chinese people are behind them.

The EU is usually less sympathetic to Taiwan's position than is the US or Japan. Thus the EU has not backed Taiwan's bid to join the World Health Organisation, suggesting instead that it affiliate as a non-governmental organisation. Nor has the EU complained about China's military build-up on the mainland close to Taiwan, as the US has.

However, Taiwan has the potential to create difficulties in the EU-China relationship. If there were a period of rising tension across the Taiwan Strait, with Beijing issuing military threats, European public opinion – and, ultimately, EU governments – would sympathise with the democratic underdog. If war did break out, and the US became embroiled, the EU could not remain neutral. But European sympathy and diplomatic support for Taiwan and the US would not translate into military assistance. No European would die to defend Taipei.

Given that the 27 EU governments do not have fundamentally different interests over Taiwan, the fact that they cannot easily forge common positions on the island is regrettable. Some of the Central and Eastern European states – having overthrown authoritarian regimes at about the same time that Taiwan became democratic – are instinctively sympathetic to it. But Britain, France and Germany tend to make a priority of not upsetting Beijing. For example, in

<sup>32</sup> Jean-Pierre Cabestan, 'The Taiwan issue in Europe-China relations', in 'China-Europe relations', ed David Shambaugh, Eberhard Sandschneider and Zhou Hong, Routledge, 2007.

April 2005 Jean-Pierre Raffarin, France's then prime minister, visited Beijing. The EU's official stance on the recently passed anti-secession law – which threatened Taiwan with the use of force – was highly critical. But Raffarin said that the law was compatible with France's one-China policy.<sup>32</sup>

In the summer and autumn of 2007, China demanded that the EU publicly criticise the Taiwanese government's plans for a referendum on applying for UN membership (which Beijing thought could be a prelude to independence). The Europeans were divided over how to respond. Solana and the Germans saw no need to do Beijing's bidding, while France was more sympathetic to it. In the end, as a

compromise, the EU made a secret *démarche* to Taipei, urging it not to hold the referendum. The Chinese, of course, were annoyed that the criticism was not public.

When Sarkozy was in Beijing in November 2007, he used harsh language towards the Taiwanese, and a few days later at the EU-China summit France helped to push the *communiqué* wording on Taiwan in China's favour. So the EU "reiterated its concern over the intended referendum on UN membership in the name of Taiwan as this could lead to a unilateral change of the status quo across the Taiwan straits to which the EU is opposed". In return the Chinese government gave the green light to the new high-level forum on economics that the Commission and itself would run (EU officials say they are not ashamed of conceding that particular wording, since the EU had used virtually the same words on previous occasions).

The Chinese lobby EU governments more strongly on Taiwan than any other issue, often using small countries such as Malta to argue for their position, while applying direct pressure to larger ones, such as Britain, when they take an 'incorrect' view. The fact that the EU finds it difficult to speak with one voice on Taiwan undermines its credibility in Taipei, Beijing and Washington. The member-states therefore need to make a greater effort to keep together on Taiwan. The EU's perspective is different to that of the US, so it should not seek a common EU-US position. But it should talk more to the US about security in the region.

As an aspiring global power, the EU needs to think more about security not only in its neighbourhood, Africa and the Middle East, but in Asia, too. As well as accounting for over a third of global GDP,<sup>33</sup> Asia hosts some of the world's most dangerous flashpoints: Burma, Kashmir, North Korea and Tibet, as well as various disputes over Himalayan glaciers and islands off the coast of the Asian continent. Any

<sup>33</sup> Calculated on a purchasing power parity basis, Asia accounted for 37 per cent of global GDP in 2006, up from 26 per cent in 1990. Bill Emmott, 'Rivals', Allen Lane, 2008.

explosion in one of these places might disrupt the world economy and could easily have major geopolitical implications. However, as with Taiwan, few European governments seem to understand the stakes, or care.

## 5 Priorities for a strategic partnership

A strategic partnership between the EU and China should focus on a small number of critical subjects. These should be issues that matter not only to the EU and China but also have wider global implications; that have the potential to disrupt the relationship (one purpose of the partnership is to increase mutual comprehension and defuse tensions); and that – if subject to a successful dialogue – could help China to modernise its economy and governance.

For a start, we suggest that the EU and China should focus on climate change, non-proliferation, Africa and global governance. Each meets the first and second of the above criteria, while climate change and global governance (especially in economics) also meet the third.

In fact, the strengthening of multilateral rules and institutions should not only be a priority for the strategic dialogue, but also an overarching objective of the partnership. In all the areas chosen for the strategic partnership, the EU should use its dealings with the Chinese to try and convince them that their interests are best served by working within global institutions and frameworks. A constructive EU-China partnership should serve to strengthen international institutions.

Some European and Chinese leaders seem to be taking some small steps towards building a truly strategic partnership. During his April 2008 visit to Beijing, before inaugurating the new high-level economics dialogue, Barroso and his colleagues met Premier Wen and a team of Chinese ministers to discuss longer-term challenges. In this 'executive

to executive' format the two sides agreed that the relationship should focus on a small number of priorities. In a discussion on climate change Barroso urged the Chinese to table their already existing domestic commitments, mainly concerning energy efficiency and renewables, in the forthcoming international negotiations on a post-Kyoto regime; that would make it harder for China to modify those commitments. The Chinese insisted on the EU providing funding for the transfer of environmental technology to them. Each side agreed to the principle of what the other had asked for.

It was during the Commission's visit to Beijing that the Chinese government announced it would meet the Dalai Lama's representatives. This move – which Barroso had requested – suggests that the Chinese leadership takes a positive view of the new formats for meeting the Commission. Another executive to executive session is planned in Brussels in spring 2009.

### ★ Priority 1: Climate change

The Europeans must make climate change the number one priority of any strategic partnership with China. There is no other area that has so much potential for fruitful co-operation between the EU and China. But there is also no area where the room for confrontation and conflict is so great. The EU is leading the efforts to construct a global system for limiting global warming after the Kyoto protocol expires in 2012. It knows that without Chinese participation these efforts are doomed. The Chinese worry about environmental degradation at home but assert that the West should bear the pain of fighting climate change since it is responsible for most of the carbon in the atmosphere.

The Europeans will not be able to persuade the Chinese to join the post-Kyoto system unless they can show that they – and the Americans – take their responsibilities seriously. The Europeans can plausibly argue that they are doing so. Led by Chancellor Angela Merkel, in 2007 the Union signed up to three ambitious

targets that it seeks to achieve by 2020: a 20 per cent reduction in greenhouse gas emissions (or 30 per cent if the rest of the world joins the effort); 20 per cent of energy to come from renewable sources; and a 20 per cent improvement in energy efficiency. Furthermore, the EU and its member-states are already doing a lot to help China make its economy greener and more energy efficient.

But if the Chinese continue their current line of resisting quantitative targets for cutting CO<sub>2</sub> emissions, the Europeans may feel they have little choice but to take punitive action. Many European industrialists, and some EU politicians, are already talking about the need to apply 'carbon tariffs' to goods from China or other countries that shun any post-Kyoto system for curbing carbon emissions. China sees such talk as de facto protectionism, driven by fear of its economic success.

China has signed the UN's Kyoto protocol on carbon emissions but, as a developing country, is not obliged to curb the amount that it emits. No scheme that replaces the protocol will succeed unless China is part of it. First, because in 2007 China overtook the US to become the world's biggest emitter of carbon dioxide. Second, because other fast emerging economies, such as India and Brazil, will not join unless China does. And third, because developed countries such as the US will not accept any post-Kyoto scheme that seeks to make them change their behaviour without binding poorer countries. Without Chinese co-operation, the world can do little to limit climate change. This puts China in a very strong diplomatic position.

### Awareness in China is rising

The Chinese authorities are increasingly concerned about environmental issues. But they have put much more effort into fighting local problems such as air and water pollution than tackling global warming. The Chinese people themselves, however,

do seem concerned about climate change. Eighty-three per cent of them say that steps should be taken to address global warming, and 42 per cent believe it is a “serious and pressing problem” that demands immediate action “even if this involves significant costs”.

Seventy-nine per cent say that if developed countries are willing to provide aid, “less-developed countries should make a commitment to limit greenhouse gas emissions.”<sup>34</sup>

<sup>34</sup> *www.worldpublicopinion.org/pipa/pdf/mar07/CCGA+\_ClimateChange\_article.pdf.*

China’s leaders, however, have stock answers prepared for those westerners who demand action from them. They point out that their country has become the workshop of the world, for example producing a third of its steel. The shift of polluting industries to China enables the West to have cleaner air and feel good about reducing its carbon emissions. They also stress that China’s carbon emissions and per capita consumption of energy are much lower than those of developed countries. For example, in 2005 per capita emissions in the US were 19.6 tonnes; in Germany 9.9 tonnes; and in China 3.6 tonnes. However, since China is building a coal-fired power station every week, it will probably catch up with the EU level of per capita emissions within ten years.

Some of China’s leaders do seem to recognise that climate change is a serious problem. It threatens to do more damage to China than to Europe: much of China’s population lives on low-lying coastal plains and is vulnerable to rising sea levels and the increasing frequency of hurricanes. China’s deserts are already enlarging, exacerbating serious water shortages. The melting of Himalayan glaciers is also a worry. A report commissioned by the central government and published in July 2007 says that climate change could cut some crop yields by 20 per cent. The leaders also worry about China’s inefficient use of energy – it is already the second biggest oil importer in the world. China’s frantic efforts to gain access to oil and gas reserves in unsavoury countries are a symptom of its growing energy insecurity.

The central government is taking measures to promote energy efficiency and curb air pollution, both of which can help to slow the growth in CO<sub>2</sub> emissions. It has set ambitious targets for achieving greater energy efficiency: the current five-year plan calls for a 4 per cent reduction in energy consumption per unit of output every year, starting in 2006, though China is already falling behind those targets. The government claims that these targets, combined with policies to promote the use of renewables, will help reduce greenhouse gas emissions.

But even if the central government decided that firm action on carbon emissions was necessary, would it have the means to enforce its rulings? In many provinces and towns, local politicians make a fetish of fast growth, often driven by large investments in heavy industries. They believe this is the best way to maintain their legitimacy, improve their prospects of promotion and, sometimes, to line their own pockets. They have regularly disregarded instructions from Beijing to curb investment and growth rates, and they may take a similarly cavalier attitude if told to curb carbon emissions.<sup>35</sup>

<sup>35</sup> *Over the past couple of years the Chinese authorities have become tougher at enforcing environmental regulations. The decision in 2008 to upgrade the State Environmental Protection Agency into a full ministry is encouraging.*

The EU and its member-states have made a priority of helping China to reduce emissions and improve energy efficiency. They have established a broad range of projects on energy and climate change with various parts of the Chinese government.

The focus of the ‘EU-China climate change partnership’ – unveiled in 2005 and managed by the Commission and China’s Ministry of Science and Technology – is the transfer of technologies for cleaner and renewable energy at minimal cost. One of its projects is the ‘near zero emissions coal initiative’, which aims to develop carbon capture and storage (CCS), a technology that captures the CO<sub>2</sub> that comes from burning coal and buries it safely underground. The technology is still under development and the aim is to build a commercially-

viable plant with CCS by 2020 at the latest. This CCS initiative is funded by both the British government and the EU's R&D programmes. The Commission also manages an energy and environment programme, together with China's National Development and Reform Commission. This has involved workshops and feasibility studies on issues such as biomass, off-shore wind power, coal-bed methane, energy efficiency standards, natural gas and clean coal.

Some of the pilot schemes spawned by these EU programmes are working well. For example, the Chinese are learning how to make industrial boilers more efficient without replacing them. But there are several obstacles to progress. One is that the EU and the Chinese tend to have different priorities. The Chinese want to concentrate on energy efficiency, seeing it as 'win-win' because it addresses the problem of climate change while reducing energy consumption and therefore costs. The EU tends to prefer projects that are purely concerned with climate change, notably CCS, even though they may slightly decrease energy efficiency (it takes energy to capture and store the emitted carbon). The Chinese are therefore reluctant to engage whole-heartedly in CCS – even when outsiders offer to pay for everything.

Another obstacle is China's challenging business environment. Widespread disregard for intellectual property rights makes investors reluctant to transfer the cutting-edge technologies that are often needed in environmental projects. Moreover, regulatory frameworks can be uncertain or discriminatory. Take renewables. In 2004 the government announced a modest target: 30 giga-watts should come from wind power by 2020. But a regulation published in 2006 laid down a 70 per cent local content requirement for wind power, which has deterred foreign firms from investing.

Another way in which European companies can transfer environmental technology and know-how to China is through so-called carbon offsets. The EU's emissions trading scheme sets caps

for the amount of carbon that industries can emit. Companies that exceed their allowances can either buy additional carbon certificates (permits to pollute), or offset the surplus by investing in projects that reduce carbon emissions in poorer countries, <sup>36</sup> *Simon Tilford, 'How to make EU emissions trading a success', CER pamphlet, May 2008.* under the UN's 'clean development mechanism' (CDM).<sup>36</sup> China accounts for 40 per cent of all the CDM credits so far created – perhaps because its energy-intensive industries offer so much scope for improvement. Although specialist bodies must verify that particular projects – such as a dam across a river, a new forest or an incinerator with carbon capture technology – reduce carbon emissions, there are many questions about their effectiveness. Some of the projects would happen anyway, without investment through the CDM, and some are of dubious environmental value. But some would not happen, and the mechanism – which could doubtlessly be improved – serves a purpose as a channel for rich countries to put money into helping poorer countries curb their carbon emissions.

But even when one adds together China's own efforts to improve energy efficiency, the many international programmes to help the country curb carbon emissions, and the CDM, there does not seem much chance of slowing the growth of China's output of greenhouse gases. The International Energy Agency, which assumes that China will learn to use energy much more efficiently, predicts that its emissions of CO<sub>2</sub> will reach 3.6 billion tonnes in 2030, a quarter of the world's total. But if China failed to break the link between growth and carbon emission, its CO<sub>2</sub> output <sup>37</sup> *http://www.sciencemag.org/cgi/content/short/319/5864/730.* would be 8 billion tonnes a year by 2030, according to an estimate in *Science*.<sup>37</sup> That is equal to the entire world's CO<sub>2</sub> production today.

In the West, growing public concern about the climate has pushed politicians to act. In China, with a much less developed civil society, there is no parallel pressure on politicians. Some journalists write about pollution, but those who become too critical of a local government may be stamped upon. There are a few environmental

NGOs – such as Green Cross, in the southern coastal city of Xiamen – which have worked hard on public campaigns to raise awareness of climate change.

Perhaps China's rulers, deservedly famed for their ability to think long term, will grapple seriously with the issue of climate change. They could use the state media to educate the public, and they could try to force local authorities to enforce environmental laws and energy efficiency targets. An emissions trading scheme, similar to that of the EU, would not be viable for now: no part of the government currently has the means to verify what individual companies emit. A serious attempt to tackle carbon emissions would require cruder, quantitative methods, perhaps focused on individual cities. If China's leaders want to be respected by their peers in many other parts of the world, they will need to find a way of shaping and joining the post-Kyoto system that is due to start in 2012.

### **The spectre of carbon tariffs**

But China's leaders may not want to do any of these things, or at least not as soon as 2012. They may decide that both the stability of their regime and the global clout of their country depend on a China-first policy of untrammelled growth. They may see climate change as a long-term challenge that can be tackled in the future, once China has overtaken the US as the world's largest economy.

If that were to be the choice of China's rulers, they would risk serious economic conflicts with the West. American public opinion is catching up with that in Europe over climate change. Both John McCain and Barack Obama take climate change seriously. The US is likely to establish some sort of cap and trade scheme, and will probably take part in whatever system replaces the Kyoto protocol. But American and European energy-intensive companies covered by such a scheme will jib at making costly investments to cut carbon emissions, if competitors in other parts

of the world are allowed to pollute without penalties. They warn that if China, India and other emerging markets remain outside the post-Kyoto scheme, more and more industries will relocate to those places (a threat described by the ugly term 'carbon leakage'). Clearly, any global scheme that did not include China and other industrialising countries would not be politically sustainable in the US or Europe.

Western governments are therefore likely to adopt an aggressive approach to any big country that rejects the post-Kyoto scheme. They may well threaten to impose tariffs on imports from countries not taking part. President Sarkozy made this threat in Beijing in November 2007. Commissioner Mandelson has warned that such threats could deter China from engaging in the talks on the post-Kyoto system. But President Barroso has acknowledged that there will be a debate on the merits of such tariffs. The case for them would be to ensure a level playing field (though there may be other ways of doing that, such as tax breaks for companies that have to compete with those outside the system). The case against carbon tariffs would be that various protectionist lobbies would support them, for the wrong sorts of reason. Such tariffs should certainly be used only as a last resort. But the Europeans and others who care about climate change may find it hard to persuade the world's major economies to join the post-Kyoto scheme, unless they threaten those outside it with some sort of penalty.

Unless China shifts its stance, climate change promises to become the biggest source of conflict between Brussels and Beijing. We think it likely that, as with other potential sources of conflict, such as Iran and Sudan, China's leaders will try to move some way towards the EU, to deflect criticism and possible penalties. But global warming is not a problem that can be solved with a few accommodating words, or a diplomatic fudge. Europe's leaders should use their strategic dialogue with China to make the point that there is no more important single issue in EU-China relations than climate change.

The battle to limit carbon emissions will dominate global governance in the coming decades. The post-Kyoto system will probably need important new global institutions to make it work. Europe will expect China to be not only a responsible stakeholder, but also a leader in helping to build these institutions.

### ★ Priority 2: Weapons proliferation

Iran's uranium enrichment programme has the potential to destabilise the entire Middle East. The US and the EU states believe that Iran is trying to develop the capability to build atomic weapons, even if it has not yet decided to build them. This nuclear programme could provoke a war between Israel and Iran, or the US and Iran. If Iran does obtain nuclear weapons, it would seriously damage the international non-proliferation regime and inspire other Middle Eastern countries to follow suit.

Iran's nuclear programme has become a test case for the EU's emerging foreign policy. Led by the 'EU 3' of Britain, France and Germany, plus High Representative Javier Solana, the European Union has sought to use both incentives and sanctions to dissuade Iran from continuing the programme. The EU diplomacy has been a success in terms of process: the Europeans have kept together; the Americans, Russians and Chinese have backed the EU's efforts; and an open rupture between the West and Iran has been avoided. The outcome, however, has been a failure: Iran continues to enrich uranium, avowedly for peaceful purposes.

Because the EU's diplomacy seeks to use the United Nations to put pressure on Iran, China, as a permanent member of the UN Security Council, has a crucial role to play. China's actions may have a big influence whether or not the diplomacy succeeds, and thus whether the nuclear Non-Proliferation Treaty (NPT) remains viable. But Iran has presented China with some difficult dilemmas. On the one hand, China believes in the principle of non-interference in other countries' affairs, and it does not want to risk endangering its commercial

interests in Iran; on the other hand, China wants to be viewed as a responsible international partner by the Americans and Europeans.

Until about ten years ago, China had an embarrassing record as a proliferator, notably through its support for Pakistani efforts to build missiles and atomic weapons. Pakistan in turn helped several other countries to establish nuclear weapon programmes. In the past few years, however, China has introduced stringent and fairly effective controls on the export of sensitive materials and technologies.

China has also become an important player in the diplomacy surrounding North Korea's atomic weapons programme. It chairs the 'six party talks' (consisting of North Korea, South Korea, China, Japan, the US and Russia) that have sought to resolve the problem of Pyongyang's nuclear weapons. Until a few years ago, China emphasised that it lacked the means to lean on North Korea. And Chinese leaders admitted that they did not want to destabilise Kim Jong Il's regime, lest the country implode, sending waves of refugees into China, and perhaps ultimately re-uniting with South Korea under the authority of a pro-American government.

But when North Korea exploded a nuclear device in October 2006, an angered Chinese leadership supported UN Security Council sanctions. And in February 2007, Beijing leaned on Kim Jong Il to sign up to a package of measures that will, in theory, lead to North Korea giving up its nuclear weapon facilities. American diplomats say that China's help has been "instrumental" in persuading North Korea to begin the dismantlement of the Yongbyon nuclear reactor.

### China's interest in Iran: trade and principle

While the EU's involvement in the Korean peninsula is limited, it leads international efforts to tackle the Iranian nuclear programme. China has become Iran's biggest trading partner, and in 2004 one of its state companies, Zhuhai Zhenrong, signed a memorandum of

<sup>38</sup> *Stefanie Kleine-Ahlbrandt and Andrew Small, 'China's new dictatorship diplomacy', Foreign Affairs, January-February 2008.*

understanding committing it to invest \$20 billion in the Iranian gas industry.<sup>38</sup> Then in late 2007 and early 2008, two leading Chinese energy firms, Sinopec and CNOOC, announced new deals in Iran. Such commercial

interests make Beijing reluctant to put pressure on Iran by supporting economic sanctions.

But China's approach to Iran is not driven solely by economic self-interest. China's style of diplomacy is to speak softly. Like Russia, it believes that attempts to bully the Iranians would be counter-productive because they would strengthen the most radical elements in the Iranian political system. For the Chinese there is also a philosophical principle at stake, that of non-interference. As the victims – in the 19<sup>th</sup> and early 20<sup>th</sup> centuries – of western imperialism, the Chinese are extremely sensitive to western powers telling less developed countries what to do. China's leaders have always had huge respect for the Westphalian idea of national sovereignty.

And yet, over the past four years, Chinese attitudes to Iran have evolved. As recently as 2004, we heard senior Chinese policy-makers say that Iran was not China's problem or responsibility. But European and American diplomats repeated to their Chinese counterparts that Iran's nuclear ambitions have global implications, and that if its nuclear programme led to warfare, the oil price would soar and Chinese interests would suffer.

The Chinese line began to shift. Chinese leaders saw that the EU-led diplomacy offered a promising route towards a peaceful resolution of the problem. They tried to persuade the Iranian leadership to support the EU's efforts. With some reluctance, China, like Russia, supported three UN Security Council resolutions – in 2006, 2007 and 2008 – that imposed moderate sanctions on Iran. "This is a shift in Chinese foreign policy," says Professor Shen Dingli of Fudan University. "China has now voted five times against Iran or North

Korea in international bodies. Even if sanctions are often ineffective, they are an important means of upholding principles in international relations. If the sanctions against Iran fail, we must increase them or accept an Iranian bomb."

However, while Russia's government has sometimes appeared genuinely annoyed with Iran's diplomatic games over its nuclear programme, China has on several occasions been less helpful to the EU-led diplomacy, perhaps because of its huge investments in Iran's energy industry (although Russia, too, has important commercial interests in the country). Though grateful that China voted in favour, European and American diplomats complain that its insistence on watering down the 2008 sanctions has decreased the likelihood of Iran changing its behaviour.

China's leaders may under-estimate their potential influence on Iran. Some of them do not seem to appreciate that China is an emerging diplomatic force. Because China is not a western or imperialist power, the Iranians listen carefully to what it says, and are particularly fearful of the possibility of Beijing supporting stronger UN sanctions. China should consider leading a new initiative involving countries such as Brazil, India, Indonesia, Malaysia and South Africa, to persuade Iran to comply with the demands of the UN and the International Atomic Energy Agency (IAEA) on its nuclear programme. Since Iran sees itself as a leader of the developing world, its leadership might find such an initiative hard to rebuff. But for the time being, that kind of assertive behaviour runs against the grain of how Chinese diplomats think.

Europeans should use their strategic dialogue with the Chinese to urge them to do more to influence Tehran. They should highlight how an Iranian bomb could set off a cascade of nuclear proliferation in the Middle East, making the region less stable and war more likely. They could point out that being a 'responsible global stakeholder' means, sometimes, suffering commercial losses for the sake of longer-term benefits. The Germans could show the

Chinese a graph of how their exports to Iran have collapsed in recent years, because of German support for various sanctions against the country. And the Europeans should remind the Chinese that if more countries acquire the bomb, their own status as a nuclear power is diminished.

With an NPT review conference due in 2010, the Europeans should encourage the Chinese to think about how the global non-proliferation regime could be strengthened. One idea would be to garner Chinese support for the idea of a 'uranium bank' – a concept backed at various times by the IAEA's Mohamed el-Baradei, Tony Blair and George W Bush. Such an institution would supply nuclear fuel to countries that wanted nuclear power stations but did not want to master the nuclear fuel cycle. Another idea would be to encourage China to sign up to the Proliferation Security Initiative – an informal grouping of countries that seeks to clamp down on the smuggling of dangerous weapons or their components, on the high seas or in the air. Most western countries are members and Russia has also joined the initiative.

### ★ Priority 3: Africa

Outside Asia, Africa is the continent where China's new global role is most visible. Its quest for natural resources has led to massive investments, growing aid programmes and thickening political ties with a host of countries. The way that China acts on this continent worries Europeans, because it has no qualms about doing business with the most brutal regimes, and because its no-strings-attached aid may undermine their efforts to persuade governments to reform. The Americans and the international financial institutions (IFIs) share the Europeans' concerns; they have watched in some dismay as Africans have praised the 'Beijing consensus' as an alternative to western models of development.

Yet China's growing interest in Africa is in many ways good for the continent. Soaring demand from China has pushed up the price of

commodities, which has benefited the many African countries that rely on raw material exports. Many Europeans welcome the growth of Chinese investment in, and aid to, African countries, which is now reaching significant levels. For example, in October 2007 China announced \$5 billion of soft loans for Congo's mining industry – more than any European government had offered – and its companies run mines in 12 other African states. In May 2007, China's Exim Bank said that it planned to provide \$20 billion of credits for trade and infrastructure over a three-year period. Given the problems of poverty and under-development that afflict many African countries, the greater the number of richer countries that take an interest in the continent, the better.

Few Europeans see Africa as the setting for a 'great game' to be played out between themselves and the Chinese. The European Union and its member-states remain the largest donors to, and investors in, Africa. They take 70 per cent of the exports from Africa's poorest countries. But some African governments find the Europeans' tone patronising and accuse them of neo-colonial attitudes. Several governments have resisted the EU's attempts to make them sign 'economic partnership agreements', on the grounds that they would impose excessive liberalisation on African economies. Meanwhile, China helps to build things like railways, roads, ports, stadiums and presidential palaces that are often popular with Africans. European aid seldom goes on such concrete projects, which are unpopular with western development experts.

The impressive spectacle of leaders from 48 African countries gathering in Beijing in November 2006 attracted much attention in Europe. At that event Hu Jintao announced \$5 billion of export credits and preferential loans, plus a \$5 billion fund to promote Chinese investment in Africa. This spurred Portugal, holder of the EU presidency in the second half of 2007, to organise a comparable 'Europe-Africa' summit in Lisbon in November 2007.

The EU's number one worry about China in Africa is its impact on governance. Chinese aid to Africa, mostly in the form of soft loans, is unconditional – except that the money usually has to be spent on Chinese goods and services, and the government concerned must not recognise Taiwan. Unlike western governments or the IFIs, China does not generally ask regimes to improve their administrations, economic policies or respect for human rights. Its approach is to engage and invest but not to criticise African governments – except, occasionally, in the most gentle manner.

Naturally, that suits a lot of African regimes. In 2002, for example, Angola rejected an IMF programme, which included conditionality, when China offered money of its own. And in 2005, when the UK cut off some aid to Ethiopia on account of its poor human rights record, China stepped in and matched the lost UK aid, pound for pound. China encourages its companies to invest in countries which, for most western governments, are more or less untouchable. There have been major Chinese investments in Sudan's oil industry and Zimbabwe's copper mines – both shunned by western firms.

### China's 'soft power'

China's approach to Africa is guided mainly by its need for quick and safe access to raw materials – but also by its belief in the principle of non-interference. China makes a point of not lecturing Africans in the way that westerners sometimes do. To many Africans, China itself offers an attractive model of development that seems more suitable than the orthodoxy propagated by western governments and international organisations.

<sup>39</sup> Joshua Ramo, 'The Beijing consensus', *Foreign Policy Centre*, May 2004.

Joshua Ramo, an American writer, coined the term 'Beijing consensus' to describe the Chinese alternative to the 'Washington consensus', and many Chinese academics liked the phrase.<sup>39</sup>

Fans of Ramo's thesis see the Washington consensus as being about the West imposing neo-liberal economics on poor countries, at the

risk of rising inequality and environmental damage. The Beijing consensus is supposed to offer a less harsh route to economic development. This model gives a larger role to the state, rejects external conditionality and seeks to minimise inequality and environmental problems. Given the dreadful levels of inequality and pollution that afflict China, the idea that its economic development could serve as a model to poor African countries seems ludicrous. But it goes down well with many Africans. President Abdoulaye Wade of Senegal says that China's approach "is better adapted than the slow and sometimes patronising post-colonial approach of European investors, donor organisations and NGOs."<sup>40</sup>

<sup>40</sup> Article in *Financial Times* special report on Africa-China trade, January 24<sup>th</sup> 2008.

In the eyes of many Africans, China therefore enjoys 'soft power' – the ability to make people do things through persuasion, and through offering an attractive model, rather than coercion. China is making a conscious effort to enhance its soft power in Africa, for example by setting up Confucius Institutes to promote Chinese language and culture, and by running educational exchanges, health projects and Chinese volunteer programmes.

However, soft power can go down as well as up. Already, some Africans are having second thoughts on whether China's involvement is really beneficial. They argue that, while Chinese investment may be helpful in the short term, in the long run it could lead to the too-rapid depletion of Africa's resources, and significant environmental damage. China's companies have been accused of paying low wages and ignoring local environmental rules. Many hundreds of thousands of Chinese workers have arrived in Africa. They generally live separate lives from the Africans, who sometimes accuse them of stealing jobs. In 2006 there were anti-Chinese riots in Zambia, and South Africa's president, Thabo Mbeki, compared China's role in Africa to that of the former colonial powers.

In January 2008, in the middle of Kenya's controversial elections, an article in China's *People's Daily* said that Africans were not

sued to democracy. This provoked an angry reaction from Kenya's opposition leaders. And China's decision in April 2008 to send a shipload of armaments to Robert Mugabe's beleaguered Zimbabwean government proved a public relations disaster. South African trade unions refused to unload the arms and neighbouring countries turned the ship away, which had to return to China.

Although many Europeans are concerned about the way China engages in Africa, its growing footprint on the continent has made them more sensitive to how their involvement in Africa is perceived.

<sup>41</sup> *European Commission communication, 'Strategy for Africa: An EU regional political partnership for peace, security and development in the Horn of Africa', October 2006.*

In 2006 the European Commission produced a new strategy paper for Africa, calling on the EU to be less patronising towards African nations and to treat them as partners rather than subjects of aid and advice.<sup>41</sup> Given that the EU (and the West more generally) does not have a great deal to show for its decades of

trying to foster development in Africa, Brussels' new-found humility is a good thing. However, the EU will not discard its conditionality-based approach, and neither will the US and the IFIs. Ultimately, better governance and economic openness are primarily in Africa's own interest.

## Rethinking Zimbabwe and Sudan

When the Europeans consider that Beijing's support for an unsavoury regime is having a particularly harmful effect, they tell the Chinese. In two particular instances, EU governments have sought to shift Chinese policy, namely over Zimbabwe and Sudan.

China has built a close relationship with Zimbabwe's president, Robert Mugabe, based on investments in minerals such as platinum. Nevertheless, western calls on Beijing to not support the regime seem to have had some effect: in February 2007, President Hu visited all Zimbabwe's neighbours but not the country itself, and China

subsequently reduced its aid. However, the fact that the economy was sliding towards disaster, endangering Chinese investments, may have had more impact than anything the EU has said.

China's support for Sudan has been more controversial because about a quarter of a million people have died in the Darfur conflict in Western Sudan. The Sudanese government has done very little to resolve the conflict, and has often supported the murderous janjaweed militias. In 2005 and 2006, China sought to protect Sudan in the UN Security Council, watering down resolutions that criticised Khartoum. China has made substantial investments in the Sudanese oil industry and, according to some reports, takes two-thirds of the country's oil.

In 2006, Chinese policy began to change, more because of American than European pressure. Americans have tended to take the Sudanese crisis more seriously than Europeans, perhaps because of the involvement of several Hollywood stars in the campaign to help Darfur. American campaigners have focused on China's vulnerable point – its hosting of the 2008 Olympics. They led calls for a boycott, demanding that China lean on the Sudanese government to rein in the militias.

Such pressure seemed to produce some results. China appointed a special envoy to Africa, Liu Guijin, whose task is not only to give advice to countries such as Sudan, but also to explain Chinese policy to Europeans and Americans. And after Hu's visit to Sudan in February 2007, President Omar Bashir finally accepted a hybrid African Union-United Nations peacekeeping force in Darfur. China then provided 315 peacekeepers for Darfur (in addition to 800 it had sent to Southern Sudan), as well as \$30 million to support the AU's contribution to the mission. By spring 2008, however, a lack of co-operation from the Bashir government had prevented most of the AU-UN force from deploying. The situation in Darfur worsened and the Sudanese government sponsored an attempted coup in neighbouring Chad.

China lacks a coherent and unified policy on Africa. While the foreign ministry wants to maintain friendly relations with the West, other ministries focus more on commercial interests. The Chinese government does not fully control the actions of some state-controlled enterprises in Africa, in particular in the energy sector. There has been a vigorous debate on Africa policy within China's policy circles in recent years. Some take a traditional line: China is a natural friend of the Africans, the neo-imperialist West has no right to give lectures to the Chinese, and the principle of non-interference is sacrosanct. But other academics and officials argue that China has an interest in good governance in Africa. After all, Chinese oilfields in central Sudan were attacked by Darfur rebels in December 2007, while nine Chinese oilmen were killed in the Ogaden region of Ethiopia in April of that year. They point out that if China does not use its influence to improve governance, the security of its own people could be at risk, for example through kidnappings; the value of its investments could suffer; and its moral authority among Africans could be undermined. Perhaps stung by criticism of the safety record of Chinese-owned copper mines in Zambia, the Chinese government recently issued 'good corporate citizen' guidelines for Chinese companies in Africa.

These arguments within the Chinese system give Europeans the opportunity to influence the way China thinks about, and behaves in, Africa. In 2007, in response to western criticism of what it was doing on the continent, China started official dialogues on Africa with the EU, and, separately, with Britain and France. The EU's dialogue, which currently involves meetings of officials, should be upgraded so that there are regular ministerial meetings. The European team should include ministers from the countries with the most experience of Africa (a minister from Portugal may have more to contribute than one from Latvia). The two sides should exchange views on what kinds of development policy work best, what interests they share on the continent, and how they can work together to pursue common objectives. For example, they might decide to collaborate on projects that rebuild war-torn Congo.

The Europeans should encourage the Chinese to become more involved in regional and multilateral projects and programmes.<sup>42</sup> China could emulate the EU in developing close ties with the African Union in Addis Ababa, as well as the continent's various regional bodies. In particular, the EU should draw China into working with the IFIs, rather than against them, while also showing a willingness to reform them so that emerging powers are better represented. The top priority for the Europeans must be to encourage the Chinese to see that a greater focus on governance would benefit them and the Africans.

<sup>42</sup> François Godement, 'The EU and China: A necessary partnership', paper presented to the annual EU Institute for Security Studies annual conference, November 2007.

#### ★ Priority 4: Global governance

In each of the areas highlighted in this chapter – climate change, non-proliferation and Africa – a partnership between the EU and China can only succeed if they work together effectively in international organisations. Each presents something of a test case for China: will it prioritise its pursuit of short-term national interests; or will it show a greater willingness to follow and shape global rules, and invest in building better international institutions that will in the long run – according to the Europeans – best serve its own interests?

China faces the same dilemma in the area that we discussed in Chapter 3, trade and investment. The EU and China will make the most of their expanding economic relationship if they both support an international system of trade and investment rules, rather than rely on economic muscle to get what they want.

China, like the EU, is an economic superpower that is also a diplomatic and military power in its neighbourhood – though not yet further afield. When it comes to taking on some of the responsibilities of a leading power, China has held back. Its leaders still talk about their country as a poor one that has been victimised by western imperialism. It sees the main institutions of global governance as run

by westerners for their own benefit. It says that it cannot be expected to assume major responsibilities in global talks on trade or climate change because it is still in the process of becoming rich.

Too often, China stays on the sidelines when international institutions are reformed. For example, in 2005, when the United Nations underwent a major round of reform, China allowed others to take the lead. As one Chinese diplomat was heard to confide: “Our instructions were to keep Japan off the UN Security Council (UNSC), and not worry too much about the rest of the reform package.” This annoyed not only the Japanese, but also the Indians and the Germans, who hope to gain permanent membership of the UNSC in any deal on its reform.

Most Europeans hope that, as China learns to define and pursue its interests across the globe, it also takes on some of the responsibilities of a superpower. There is some evidence that it is starting to do so. As already described, China has in the past few years become more helpful on North Korea, Iran and Sudan.

It has also made an increasingly useful contribution to international peacekeeping. China has provided small numbers of peacekeepers (mostly non-combatants) to UN operations since the early 1990s. But in recent years, it has stepped up its support, despite suffering casualties. In the summer of 2006, China provided 1,000 peacekeepers for the UN mission on the Israel-Lebanon border. The following year it opened a peacekeeping centre to train its troops for UN missions. It has now supplied a total of about 7,000 personnel to 16 UN missions, of which 1,800 are currently deployed. Nevertheless, its overall contribution remains limited: other Asian countries, such as Bangladesh, India and Pakistan, provide many more peacekeepers.

### **The responsibility to protect**

After the UN reforms of 2005, China joined the entire General Assembly in signing up to the concept of the ‘responsibility to protect’:

We are prepared to take collective action, in a timely and decisive manner, through the Security Council...on a case-by-case basis and in co-operation with relevant regional organisations as appropriate, should peaceful means be inadequate and national authorities manifestly fail to protect their populations from genocide, war crimes, ethnic cleansing and crimes against humanity.<sup>43</sup>

<sup>43</sup> *United Nations General Assembly, ‘2005 world summit outcome’ (Article 139), September 15<sup>th</sup> 2005.*

The crisis in Burma, in September and October 2007, indicated that China has become more willing to compromise – to a modest extent – on the principle of non-interference. Until Than Shwe and his generals ruthlessly suppressed this bout of popular unrest, China had not put much pressure on them to soften their regime. Indeed, in January 2007, China had – together with South Africa and Russia – voted against a UNSC motion that criticised the Burmese government. Like the ASEAN countries, China had always argued that quiet persuasion was the best way to influence the generals.

China’s considerable interests in Burma, ranging from oil pipelines to offshore gas fields to naval bases, made it reluctant to criticise the regime. But they also made China concerned about the stability of the country. So even before the government started shooting unarmed monks, Chinese diplomats had opened a dialogue with opposition leaders and several of the rebel tribal groups. And when the rebellion began, Beijing cajoled the government to allow the UN special envoy, Ibrahim Gambari, to enter the country and meet Aung San Suu Kyi, the opposition leader under house arrest. China then supported a UNSC statement that deplored the violence.

China’s leaders had understood that the world perceived them as the principal backers of the Burmese regime; and that if they continued with their uncritical stance, they would be blamed for what happened in Burma. That would damage China’s international reputation and, possibly, the success of the Olympic games.

Presumably, the CCP does not want to see a successful transition to a western-style democracy in Burma; the example to its opponents within China could be dangerous. But it has probably concluded that a *junta* which neither reforms nor engages with the opposition will foment instability and perhaps revolution. China's efforts to push the regime to change appeared genuine, according to western diplomats closely involved. In the early months of 2008, the generals – seeing that the world's attention had turned elsewhere – became less willing to co-operate with United Nations. But in May, when the Than Shwe government obstructed foreign aid efforts after a massive cyclone killed over 100,000 people, China tried to persuade the regime to be more open to outside help.

The EU should not conclude from the example of Burma – or Iran, North Korea or Sudan – that the Chinese Communists are about to abandon their strong support for the principle of non-interference. They will not want to make any kind of ideological shift that would make it easier for the western powers or the UN to get involved in Xinjiang, Tibet or cross-strait relations. And China's leaders do not forget the 'century of humiliation', from the mid-19<sup>th</sup> to the mid-20<sup>th</sup> century, when it was bullied and invaded by foreign powers.

However, China's acceptance of the responsibility to protect suggests that, as it takes on a larger role in world affairs, it is moderating its absolute attachment to national sovereignty. So does its support for the international diplomacy dealing with North Korea's nuclear programme. In his address to the 17<sup>th</sup> Party Congress in October 2007, Hu Jintao emphasised the importance of the UN Charter and of international law.

Europeans should be patient, as Chinese thinking on sovereignty evolves. "It is so slow, we look at this case by case, there are not going to be any revolutions, we are not going to say we scrap the principle of non-interference," says Feng Zhongping, director of the European department at the China Institute for Contemporary International Relations. "But in practice we are changing it, bit by bit, pragmatically."

## China needs strong international economic rules

China's leaders have a strong focus on their country's immediate interests, so it will be a while before they are willing to take on more responsibilities for global security, dealing with failed states or preventing atrocities. But China is already one of the world's biggest economies. So it should take a stronger interest in how rules for global trade and investment are made, and in how disputes are resolved. The current system of global economic governance largely fails to reflect the rise of China, India and other emerging powers.

For China, this is a good time to assume more responsibilities in global economic governance (see box on page 96). The IMF and the World Bank – set up after the Second World War to help rebuild and stabilise the world economy – are searching for new *raison d'être*. Developing countries see the World Trade Organisation (WTO) as biased to the interests of the richer ones. But if the Doha round of multilateral trade talks cannot be revived, and the WTO loses much of its relevance as a result, the emerging countries would suffer most. The G8 summits have become unrepresentative and ineffective; China, India and other new economic powers will eventually have to be included.

The EU should argue to the Chinese that strong global rules on trade and investment are in their interest – not least to avoid a worsening of the economic tensions described in Chapter 3. But the Europeans should also show their willingness to support serious reforms of international financial institutions. In recent years, sensible schemes for reform have become stuck because individual European countries have refused to give up seats and voting shares. Some modest proposals for rebalancing are now going through the IMF. But Europe remains over-represented in the IFIs, relative to its shrinking share in the global economy, and the emerging powers under-represented. The Europeans and the Americans must share the blame for maintaining the unwritten rule that an American has to run the World Bank and a European the IMF. However, many Americans and Europeans are coming

round to the view that the global economic institutions must choose between reform and irrelevance.

So the Europeans should use their dialogue with the Chinese on global governance to bring China closer to existing economic institutions, while at the same time discussing how they can be reformed to give China better representation. The EU should also start a dialogue with China on the creation of new institutions, such as those that will be needed to manage the global system for curbing carbon emissions, or to bring together the principal producers and consumers of energy. Current institutions cannot be reformed, or new ones created, without China's active involvement.

China's foreign policy is still predominantly hard-nosed and realist, focused on the pursuit of the national interest. But that should not prevent the Europeans from seeking to draw China towards the principle of multilateralism. The Europeans can make a convincing case that China has an interest in strong international institutions:

- ★ If climate change gets out of control, China is liable to suffer more than Europe. The lack of an accord on a new international system for tackling it could provoke protectionism. China should therefore support the creation of an effective post-Kyoto system.
- ★ If more countries acquire nuclear weapons, China's status as one of a small number of nuclear powers will be affected, and the world will become a more dangerous and unstable place. China should therefore support a stronger non-proliferation regime.
- ★ If China wants to safeguard its growing economic interests in Africa, it should work with the Europeans, Americans and the IFIs to promote security, prosperity and better governance among the African states.

- ★ And it is obvious that the world's second biggest exporter (after Germany) needs strong and effective institutions to ensure that trade and investment can flow smoothly across borders.

On their own continent, the Europeans have taken multilateralism further than people in any other part of the world. They are especially well-placed to argue that multilateralism can serve China's interests at the global level.

## China and global economic governance

### The IMF and World Bank

In the current debates over reform of the IMF and the World Bank, China has played a limited but important role. It has supported calls for an adjustment of the distribution of voting rights in both organisations, to reduce the current under-representation of emerging economies. And it has joined the chorus of voices that criticises the way in which a clique of American and European countries stitch up the leadership of the IMF and World Bank. Although these two international financial institutions are of limited direct use to China, it thinks they could help to give developing countries a greater say in global economic rule-making, and to remind rich countries of their promises to spend more on aid for poorer countries.

The IMF is no longer in much demand as a lender of last resort to governments that fall on hard times. Many emerging countries have learned their lessons from past crises and stashed away large reserves of foreign exchange. With \$1.6 trillion of reserves, China is highly unlikely to require balance of payments support from the IMF. Moreover, Chinese officials – like some of their counterparts in Africa, Asia and Latin America – think that the Fund's traditional orthodoxy of open markets, free flows of capital and floating exchange rates has contributed to past crises.

To stay relevant, the IMF is looking to adopt new tasks, such as supervising the global financial system and giving early warnings of crises; setting rules for sovereign wealth funds (SWFs); and helping to redress global macro-economic imbalances. China supports a stronger role for the Fund as an early warning mechanism but has dismissed IMF calls for it to speed up the reform of its exchange rate regime as "disturbing meddling". China could still benefit from the IMF's expertise in helping it to redress the domestic macro-economic imbalances with which it is now struggling. And it should obviously take a keen interest in IMF efforts to work out a code of conduct for SWFs.

Although the World Bank has lent China more than \$40 billion to date, Beijing now has enough of its own money to finance its infrastructure and environmental projects. China itself is becoming a big lender to the developing world, and its unconditional lending to poor states in Africa and elsewhere sometimes undermines the World Bank's role. But there are some signs that China and the Bank may be willing to work together rather than against each other. China is starting to contribute to the Bank's lending vehicle for the very poor, and it is becoming more engaged in debates about development strategies. In a clear sign that the Bank is seeking stronger links with China, it has appointed Justin Lin Yifu – who has close ties to the Chinese government – as its chief economist.

### The WTO

Although China's role in the World Trade Organisation has been reasonably constructive since it joined in 2001, it is clearly punching below its weight. During the Doha round of multilateral trade talks, it has left India and Brazil to speak for much of the non-western world, despite the fact that the outcome will have a big impact on the Chinese economy. In some ways this shyness is to be expected. "The Chinese are still settling in", says one senior WTO official, "and they do so the Asian way, gently, not like a cowboy bursting into the saloon with guns blazing. They don't want to scare anyone." China is conscious of its economic clout. It knows that one reason why many poor countries are reluctant to lower trade barriers is that they fear a flood of Chinese imports.

However, now that China has been in the WTO for several years, its low-key approach is becoming harder to justify. In 2007 the other WTO members acknowledged China's growing importance by electing the first Chinese national to sit on the WTO dispute settlement mechanism.

China – alongside the EU and the US – needs to show leadership in order to avert the complete failure of the Doha round. On agriculture and services, China has opposed ambitious liberalisation plans, arguing that it had to do so much to enter the WTO in 2001 that it simply cannot deliver anything further. Similarly, on manufacturing, China has been reluctant to accept the tariff cuts offered by other poorer countries. China argues that because of its special status as a 'recently acceded member' it should not be expected to undertake further liberalisation. The EU has dismissed this argument as unacceptable.

A failure of the Doha round would gravely weaken the WTO and the multilateral trading system. The proliferation of bilateral trade deals would accelerate. If all the bilateral trade deals that are currently being negotiated or planned went through, there would be 400 of them by the end of the decade, and that could well mean the end of the principle of non-discrimination. China, as one of the world's biggest trading nations, may think it has enough economic muscle to benefit from a move towards bilateralism. But since China is so intricately integrated into global supply chains, a proliferation of bilateral deals – with their differing liberalisation schedules and contradictory rules on the origins of components and goods – would hurt its economy. As the world's second biggest exporter, China clearly has an interest in defending the multilateral trading system against the threat of fragmentation. Moreover, the Chinese authorities still need the WTO as an 'external anchor' for reforms and to stave off protectionist pressure at home.

#### **The G8**

The initial focus of the G7, an informal club of the world's biggest economies, was to manage exchange rates among its members. Today, the G8 (as it has become, with the addition of Russia) has become unrepresentative, excluding some of the world's biggest and fastest growing economies such as China and India. And the big global imbalances are between members and non-members. Moreover, the agenda of the G8 has broadened to include development, climate change and financial stability. None of these issues can be addressed properly by the current members alone.

It is true that since 2000 the G8 leaders have invited selected emerging powers to their summits. However, each G8 presidency decides whether to invite the so-called outreach countries (the 'O5' are Brazil, China, India, Mexico and South Africa) and what to discuss with them. Germany, which had the G8 presidency in 2007, formalised the outreach arrangement by setting up the 'Heiligendamm process'. This provides for continuing discussions rather than ad hoc meetings, and allows the O5 countries to feed their views to the G8 before the summits, rather than simply wait to be presented with the conclusions.

The G8 countries know that eventually they will have to invite other countries as full members, to create a more representative club, perhaps a G13. The Japanese, who run the G8 in 2009, are unlikely to press for the full

membership of China and other emerging countries. And some G8 countries argue that China should not join what they see as a club of rich democracies, although that argument carries a lot less weight after Russia's descent towards authoritarianism. The Chinese themselves have been coy about becoming a full member of the G8, fearing that this could burden them with more responsibility for dealing with global economic imbalances, climate change and development issues.

But China should seize the initiative by making the case for a reformed G8+. Changing the G8 should not be too difficult, since it is a flexible and inter-governmental body, without a secretariat, assembly or charter. Inside a new G13, China should show that it is willing and able to play a leading role in global economic governance, for example by pressing to change other institutions, such as the IMF, or building new ones, for example a global carbon authority.

## 6 Conclusion

For the first 50 years of its existence, the EU's main focus was internal integration. It has largely accomplished this task, through the building of strong institutions, the creation of the single market and the euro, and the forging of common policies on issues ranging from support for farmers to recycling waste to the treatment of asylum seekers. In the coming decades, the EU's main challenges will be external, on issues such as stabilising its potentially volatile neighbourhood, securing its energy supplies, combating climate change, fighting international terrorism and organised crime, and preventing the proliferation of weapons of mass destruction.

In most of these areas, the Europeans now have to reckon with the Chinese. Just like the EU, China is going global. China's expanding international activity is driven mainly by internal needs, most notably its hunger for hydrocarbons and other raw materials to feed its booming economy. China's willingness to support some of the more questionable regimes around the world, in return for long-term energy deals, has led to tensions with Europe. China's foreign policy has sometimes fuelled western concerns about its different approach to human rights and individual freedoms.

Furthermore, China's model of economic development is leading to friction with the EU and the US. China's heavy reliance on industrial exports, combined with an increasing reluctance to open its domestic markets, is exacerbating global imbalances. The Europeans have now joined the Americans in complaining about their bilateral trade deficit and the undervaluation of the renminbi. China's carbon emissions will become another source of tension. Since China is now the world's biggest emitter of CO<sub>2</sub>, no post-Kyoto deal can

function without it. Yet China remains reluctant to sign up to global targets for curbing greenhouse gas emissions.

The EU and China have been working on their bilateral relationship for more than two decades. Yet their purported ‘strategic partnership’ is ill-suited to deal effectively with the challenges discussed in this report. Their bilateral dealings tend to be unfocused, heavily dominated by economics, and mostly concerned with the short term – whether anti-dumping duties on ball bearings or protests in Tibet.

When the EU deals with China, as with any other great power, it needs to learn to define its own interests. A lot of these are economic. And in that domain the EU can often, through the Commission, speak with one voice. But the EU and its member-states have a poor record of thinking strategically about their interests in foreign policy, whether on China or other issues. The institutional reforms that EU countries agreed upon in the Lisbon treaty should help. Much more important, however, will be the ability of the Europeans to generate the political will to forge common policies.

A productive EU-China partnership requires the Europeans to learn to speak with one voice. If they fail to do so, the EU will be less interesting for the Chinese, who will play off EU governments against each other. And Europe would then have less ability to influence Chinese policy.

As the EU starts to shoulder more global responsibilities, it will expect China to do likewise – working through the same organisations and institutions and, hopefully, pursuing similar objectives. But it is not clear that China is heading towards becoming the ‘responsible global stakeholder’ that Europeans hope to see. Increasingly aware of its burgeoning capabilities, China could prefer an international system that is driven by hard military and economic power rather than rules and institutions. It could prefer a

world in which the major powers form alliances with those that share their world view, and oppose those who think differently. In that kind of system, the emerging rivalry between the US and China would be more likely to turn nasty; ‘win-win solutions’ – a phrase beloved of Chinese leaders – would be harder to find.

Such a world would be uncomfortable for Europeans, who are wedded to post-modern ideas of co-operation and sharing sovereignty, and who like to rely on international rules and persuasion to deliver what they want. Most Europeans believe that the biggest global problems can only be tackled by all the main powers working together.

The EU therefore has a strong interest in nudging China towards multilateralism. It stands a much better chance of convincing China of the benefits of multilateralism than the Americans, who have a tendency to act unilaterally and disregard international bodies such as the United Nations. The best way for the EU to convince the Chinese is to demonstrate – through practical co-operation on common challenges – that working through international rules and organisations delivers the results that they want.

That seems pretty self-evident in economics: China, as the world’s second biggest exporter, needs open markets, clear rules on trade and strong dispute settlement mechanisms. And China’s ‘sovereign’ investments overseas would cause less concern if they took place within an internationally agreed framework, such as those currently being drawn up by the IMF and the OECD. The EU and China are among the biggest beneficiaries of cross-border flows of goods, services, capital, technology and skills. They should work together to convince the world’s other powers to maintain an open global system.

Yet the EU cannot argue convincingly that it is working with China to strengthen global economic governance when it is toughening its trade policy in response to growing protectionist pressure in some

member-states, and when several EU governments are hastily drawing up their own rules to fend off unwanted investments from sovereign wealth funds. Such actions send the wrong signals to the Chinese. Moreover, growing economic tensions risk spilling over to the still fragile political relationship between the EU and China. Yet this is the time when the EU and China should be strengthening their political ties, given the number of pressing global challenges that both face.

In order to construct a more solid and durable relationship, we suggest that the EU and China should focus their strategic dialogue on three issues: climate change, non-proliferation and Africa. In those three areas, and in their common interest of maintaining an open global economic system, the EU and China stand the best chance of fruitful co-operation if they work through multilateral channels, or together help to draw up new international rules. Such an approach would increase the chances of the multipolar world emerging in a multilateral form, rather than in the shape of two or more hostile camps.

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# CAN EUROPE AND CHINA SHAPE A NEW WORLD ORDER?

**Charles Grant with Katinka Barysch**

A new world order is emerging, with multiple centres of power. But will this order be multilateral, with governments accepting global rules and institutions? Or will the strongest states assert their interests unilaterally, without regard to international law? The relationship between the EU and China could determine the outcome. If the Europeans can persuade China that multilateralism serves its interests, the international system may tilt towards co-operation rather than competition. The authors argue that the EU and China should build a strategic partnership focused on global issues that matter to both sides and are best addressed multilaterally: climate change, nuclear proliferation, Africa and maintaining an open system of trade and investment.

Charles Grant is director and Katinka Barysch is deputy director of the Centre for European Reform.

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