Journal of
WORLD TRADE

Published by:
Kluwer Law International
PO Box 316
2400 AH Alphen aan den Rijn
The Netherlands
Website: www.kluwerlaw.com

Sold and distributed in North, Central and South America by:
Aspen Publishers,
Inc. 7201 McKinney Circle
Frederick, MD 21704
United States of America
Email: customer.service@aspenpublishers.com

Sold and distributed in all other countries by:
Turpin Distribution Services Ltd.
Stratton Business Park
Pegasus Drive, Biggleswade
Bedfordshire SG18 8TQ
United Kingdom
Email: kluwerlaw@turpin-distribution.com

Journal of World Trade is published six times per year.

Print subscription prices, including postage (2012):EUR 967/USD 1289/GBP 710.
Online subscription prices (2012):EUR 895/USD 1194/GBP 658 (covers two concurrent users).

Journal of World Trade is indexed/abstracted in the *European Legal Journals Index*.

Printed on acid-free paper.

ISSN 1011-6702

Printed and Bound by CPI Group (UK) Ltd, Croydon, CR0 4YY.

Journal of WORLD TRADE

Volume 46 April 2012 Number 2

Unravelling Harmony: How Distorted Trade Imperils the Sino-European Partnership

Jonathan HOLSLAG*

One of the main drivers of Sino-European cooperation has been the prospect of a mutually beneficial division of labour. In the best classic liberalist tradition, it was the Chinese government that nurtured a sense of economic harmony. This paper shows that a mutually beneficial partnership has not emerged. Departing from a detailed six-digit commodity export dataset, it demonstrates that the division of labour has blurred. Furthermore, Europe's growing deficits on the current account balance were not offset by inflows on the financial account. All these are symptomatic for the twin distortions that have developed in China and Europe, twin distortions that now require difficult twin adjustments. However, while both sides preach the need for rebalancing, they tend to persist in unsustainable policies, which will still most likely lead to panic and protectionism. In that regard, the Sino-European relations reveal compellingly that politically induced imbalances cause havoc in international trade relations, even if there were no initial intentions to harm other countries' economic interests, and that the optimist narratives of harmony of economic interests cannot be trusted, as long as they are not matched by free markets.

1 INTRODUCTION

'China and the European Union are highly complementary economically', Chinese Premier Wen Jiabao stated in 2004, 'As the world's largest developing country, China enjoys a huge market potential and abundant human resources, and it is advantageously placed in receiving international transfers of industries and technologies'.[1] The prospect of mutually beneficial economic relations has been a cornerstone in Chinese official discourses towards the European Union. China's economic rise, the rationale goes, creates ample opportunities for European exporters of advanced goods, generates income for investors, and helps companies in Europe finance their expansion plans. The European sovereign debt crisis added momentum as China presented itself as a committed supporter of the Euro and a potential investor in struggling Member States.

* Research fellow at the Brussels Institute of Contemporary China Studies of the Vrije Universiteit Brussels (jholslag@vub.ac.be). I thank Michael Pettis, Jonas Parello-Plesner, Zhou Hong, Zhang Xiaotong, Kerry Brown, and Zhang Yansheng for their valuable comments and insights.

1 'Vigorously Promoting Comprehensive Strategic Partnership', speech by Wen Jiabao at the China-EU Investment and Trade Forum, 6 May 2004.

Holslag, Jonathan. 'Unravelling Harmony: How Distorted Trade Imperils the Sino-European Partnership'. *Journal of World Trade* 46, no. 2 (2012): 221–238.

Expectations of profitable trade have been the most important driving force of cooperation between China and Europe. In a previous paper, I concluded that in the absence of a strategic partnership, which implies effective cooperation on a unique set of durable common interests, commercial expectations were vital to keep relations afloat.[2] This follow-up paper assesses the reliability of commercial motivations as the main building blocks of the Sino-European relationship. The most optimistic scenario, as described by Premier Wen and several other senior officials, forecasts the development of a sound division of labour. Interestingly, the idea of a division of labour can be traced back to the writings of liberal economists like Adam Smith and David Ricardo. It prescribes that in an open global market, countries compete, and will do even more so as the channels of commerce diversify, but that competition gradually leads to specialization, which in turn stimulates growth and creates opportunities for even more commerce.[3] However relentless the race for market share and profit, free competition enlarges the wealth of the world and distributes prosperity fairly equally among different nations. It might well be that a country lacks the capacity to produce technologically sophisticated goods or sees its leading edge one sector shrink, but then the success of the other would create demand for new kinds of goods or services and reveal different comparative advantages. This formula is one of the reasons for liberals to

2 J. Holslag, 'Elusive Axis', *Journal of Common Market Studies* 49, no. 1 (2011).

3 Norman Angell most forcefully defended this thesis, and it is worth quoting the following paragraph that summarizes most key principles of the liberal theory of international relations: 'The relations of states are rapidly modifying in obedience to quickly changing conditions – the greater divisions of labour set up by quicker communications, that this intensified division of labour sets up a condition of necessary interdependence between those who share the labour, that this condition of interdependence in its turn involves a necessary subsidence of the factor of physical force as between them, that this subsidence of physical force not only weakens the role of political control, but the very complexity of the division of labour tends to set up cooperation in groups which cut right athwart political frontiers, so that the political no longer limits or coincides with the economic, and that, finally . . . you get hat I may term telegraphic financial reaction – a condition of sensibility by which the organism as a whole becomes quickly conscious of any damage to a part'. N. Angell, *The Great Illusion* (New York: Cosimo Classic, 1909/2010), 157. Also: R. Keohane & J. Nye, *Power and Interdependence* (Boston: Little and Brown, 1989), 24; D. Copeland, 'Economic Interdependence and War: A Theory of Trade Expectations', *International Security* 24, no. 4, 5–41; M. Doyle, 'Kant and Liberal Internationalism', in *Toward Perpetual Peace and Other Writings on Politics, Peace, and History*, ed. J. Waldron, M. Doyle, & A. Wood (Yale: Yale University Press, 2006), 299. Richard Rosecrance added that expectations of a mutually beneficial division of labour are at least as important as actual trade flows. Cf. R. Rosecrance, *The Rise of the Trading State* (New York: Basic Books, 1986), 28. John Ruggie also endorsed that the division of labour generated global growth and advanced cooperation but added that states can adjust changes by social spending. Cf. J.G. Ruggie, *The Antinomies of Interdependence: National Welfare and the International Division of Labor* (New York: Columbia University Press, 1983). For neofunctionalists like Ernest Haas, the division of labour among welfare states allowed groups to organize themselves transnationally. E.B. Haas, 'The Study of Regional Integration', *International Organization* 24, no. 4 (1970): 607–646. For constructivists, the division of labour is important in collective identity formation. 'A division of labour increases the extent to which actors are interdependent and suffer a common fate', Alexander Wendt writes. Cf. A. Wendt, *Social Theory of International Politics* (Cambridge: Cambridge University Press, 1999), 356.

be generally optimistic about trade as a harbinger of stronger interdependence, cooperation, and peace.

If one accepts that free commerce between China and Europe further matures, there is also reason to be confident that the imbalances in the economic relationship cannot but flatten out. Liberal theory prescribes that a country's eventual decrease in exports is compensated by capital inflows. The balance of payments always tends toward equilibrium.[4] Losses on the trade balance either lower the value of a country's currency, which gives its exporting industries a new advantage and puts a brake on imports, or are compensated by inflows on the capital account balance. Prosperity must thus spread out, and trade imbalances can only be temporary. While this paper primarily takes interest in the Sino-European economic relationship, this inevitably forms an important case for testing the relevance of these two optimistic liberal assumptions – the emergence of a mutually beneficial division of labour and the redistributing effect of the balance of payment – in the changing global economic order.

While globalization, the rapid expansion of international trade, and the reluctance of states to retrench into protectionism during the recent economic crisis have attested to these classic liberalist premises, one could have various doubts about the beneficial impact of trade on international relations. Realists maintain that free markets do not exist and that the principles of free trade therefore do not guide states' behaviour.[5] Instead, states are concerned about economic security, job creation, the maintenance of financial stability, the reduction of exposure to external risks, and their influence over economic development so as to foster national unity. As this makes them wary of economic losses to other states, states only selectively adopt the principles of free trade.[6] States seldom turn their back on the expanding flows of the global market but rather try to manipulate those flows to the benefit of their economies. Support for openness ultimately depends on their economic power, but if the possible gains in terms of trade revenue, technological know-how, or job creation outweighs the risks of retaliation, states will not refrain from distorting trade and free riding. Even liberal students of international politics have recognized that states still have an impact on markets and seek to avoid the costs and risks related to economic adjustment. In the field of political economy, the new trade school has revealed numerous ways in which the market-induced adjustments expected by classic

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4 E.F. Heckscher & B.G. Ohlin, *Heckscher-Ohlin Trade Theory* (Cambridge, MA: Massachusetts Institute of Technology (MIT) Press, 1991); A. Krueger, 'Balance-of-Payments Theory', *Journal of Economic Literature* 7, no. 1 (1969): 1–26; A. Dixit & N. Norman, *Theory of International Trade: A Dual General Equilibrium Approach* (Cambridge: Cambridge University Press, 1980).

5 For example: R.M. Stern, *The Balance of Payments: Theory and Economic Policy* (London: Macmillan, 1973); N.S. Miller, *Balance of Payments and Exchange Rate Theories* (New York: Edward Elgar, 2002).

6 K. Waltz, *Theory of International Politics* (New York: McGraw-Hill, 1979), 130.

liberalist scholars are overruled by state policies. 'No government likes being forced to compromise key policy goals for the sake of restoring external balance', Benjamin Cohen writes, 'All, if given a choice, would prefer to see others make the necessary sacrifices. In monetary affairs, therefore, the essence of state power is the capacity to avoid the burden of adjustment required by payments imbalance'.[7]

This paper finds that the classic liberal suppositions do not match with reality of the Sino-European relations. Between 2000, the moment that China was still negotiating to accede the World Trade Organization, and 2010, the division of labour has blurred significantly. The first part shows that Chinese and European exports are looking increasingly the same. This means more competition. Neither has the balance of payments found a new equilibrium. As the second part demonstrates, imbalances have only become more perverted. The final part explains the political causes of this evolution. Governments on both sides of the Eurasian continent pursued policies to maintain social stability. Excessive support for households in Europe and an ambitious investment-driven industrial policy in China were considered shortcuts to stability and prosperity. These policies were well intended and by no means aimed to undermine each other's economic security. Quite the contrary: their imbalanced growth trajectories were interdependent and permitted even larger distortions. The tragedy is that now both Europe and China seek to redress their distortions; they will be forced to do this in step as well. However, as this inevitably coincides with growing economic insecurity, such a coordinated adjustment is hard to achieve. For all these reasons, the Sino-European relationship painfully shows that optimism about mutually beneficial cooperation in a globalized world can only turn into disappointment as long as the rules of free market are overruled by the ambitions of states.

2 THE DIVISION OF LABOUR

It is widely held that Chinese exports are large in quantity but modest in terms of value added. China exports a lot of cheap products, and its advanced goods are not much more than a modest assemblage of sophisticated components that originate from all over Asia. It would, in other words, not be difficult for the European Union to develop a rewarding division of labour with the People's Republic. Nevertheless, how can we examine such trend in a quantitative way? Trade

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7 B. Cohen, 'The Macrofoundations of Monetary Power', in *International Monetary Power*, ed. D. Andrews (Ithaca: Cornell University, 2006), 31–51. Also: P. Krugman, *Strategic Trade Policy and the New International Economics* (Cambridge: MIT Press, 1986); G. Grossman & H. Horn, 'Infant Industry Protection Reconsidered: The Case of International Barriers to Entry', *Quarterly Journal of Economics* 103, no. 4 (1988): 767–787; G. Grossman (ed.), *Imperfect Competition and International Trade* (Cambridge, MA: MIT Press, 1997).

specialization is most often measured by the revealed comparative advantage (RCA) index, which compares the share of a good in countries' exports to the share of that good in the exports of a larger number countries. This certainly is a very useful approach if one studies products one by one but not when one is to examine the overall export patterns of countries.

The complementarity index, which I used for the first time in a 2006 paper, offers a solution. Per cluster of goods, plastic buckets, for example, it takes the absolute value of the difference between the exported values of two countries and divides that by their overall exports. If we do this for all clusters of exported goods, we can aggregate the result in a single index between 0 and 1.[8] Logically, 1 means complete complementarity and 0 no complementarity at all. In other words, a low score means strong competition, a high score strong specialization. What is very important is to apply this to a large enough number of clusters of goods. The more detailed the classification of goods, the more detailed the outcome. For example, if one were just to look at electronic apparels, complementarity would probably be very low, but if one splits electronic apparels up into radios and televisions, there could be complete complementarity. For this paper, I have drawn from the six-digit Harmonized System (HS) categories of the UN Comtrade database, which is the most fine-grained picture possible. In case of Chinese and European exports, my dataset included 5,775 different kinds of goods.[9] The result is most significant: the complementarity index for European and Chinese exports dropped from 85% in 2000 to 65% in 2010. Interpreting the same figures differently, 35% of their exports now overlap, compared to only 15% in 2000. This means much more competition.

That Chinese exports augmented by USD 1.3 trillion during this period and European exports by USD 1.0 trillion cannot but confirm that China has become more competitive as a trading nation. The question remains, however, in which categories of goods China made progress compared to Europe. A first glance at the two-digit HS statistics of the UN Comtrade database, good for 100 categories, reveals a huge leap of Chinese exports of electronic equipment and machinery. European exports did better in the car industry and pharmaceutical products, but in terms of trade volume, these remained modest. For all other categories, export growth was similar. If we disaggregate the Chinese exports further, to the level of six-digit HS categories, we find among the best performing Chinese products no longer a lot of basic goods, like textiles, but a diverse number of household durables, high-tech components, as well as goods for the transport sector. Laptops

8 The trade complementarity index: $\Sigma abs(export_{ax}-export_{bx})/\Sigma export_a+export_{b,}$ for which countries a and b and commodity category x.

9 The dataset can be downloaded from the following website, <www.vub.ac.be/biccs/site/assets/files/Jonathan%20misc/Unravelling%20source%20file.pdf>.

and mobile phones from China were the largest contributors, confirming the notion that its exports largely continued to be goods assembled with components from other countries to which not much value is added. As we know, only a few percentages of the retail price of a smart phone or a laptop ends up with Chinese workers, entrepreneurs, or governments. Yet, among the best performing products, one can also discover a lot of high-tech parts for mobile telephones, computers, photovoltaic systems, and other electronic products. Furthermore, we find cargo ships, scooters, and tanker ships. Europe retained its weight in the car, aircraft, and pharmaceutical industries. Increases of Chinese exports in these sectors were small, but China seemed to have made its first steps nonetheless. Between 2000 and 2010, the number of person cars exported augmented from 5,000 to almost 800,000, the quantity of car parts from 5,000 tons to 800,000 tons, the number of planes from 50 to 110, the value of medical instruments from USD 3 million to over 1 billion.

It is unlikely that the trend of reducing complementary will slow down. In plain language: Europe's advantages will probably diminish further. In the machinery sector, complementary at six-digit level is dwindling rapidly, with China making foray in most of the 530 clusters of machinery products. For the *automotive industry*, China has ambitious plans to become a key producer of traditional cars, hybrids, public transport, and car parts. The 2004 Automotive Industry Development Policy laid the fundaments for this expansion, and ever since, the government has only become bolder and more generous in supporting the car industry. Billions of government loans have been allocated to support domestic companies and innovation plans, while, simultaneously, foreign investors continued to flock into the country, ramping up their production capacity to serve the Chinese market, and to supply big car producers that see China as their new regional export hub.[10] As almost all surveys forecast the shortage in production capacity to turn into large surpluses, one can only expect the car industry in China to look more to markets abroad. For European producers, this means that they will have to choose between downscaling production in languishing European markets or reining in their expansion plans for one of the fastest growing economies. In addition, the car business expects that for the next generations of hybrid vehicles, China will become a tough challenger, if not superior to Western firms.[11] At a round table on the future of the German car industry, still the largest producer in

[10] P. Waldmeier, 'Beijing Presses Carmakers to Share Technology', *Financial Times*, 18 Feb. 2011; P. Shadbolt, 'Chinese Fund Targets Car-Related Operations', *Financial Times*, 24 Jul. 2011.

[11] Interview on the Chinese automotive industry with expert at the European Automobile Manufacturers' Association, Brussels, 6 Sep. 2011; Interview on the Chinese automotive industry with advisor to Volkswagen, Berlin, 9 Sep. 2011; Interview on the Chinese automotive industry with representative of Volvo, Ghent, 27 Sep. 2011.

Europe, most representatives assumed that Europe might be able to maintain its advantage of having strong brands but that production for the emerging markets will increasingly happen in the emerging markets themselves and that, as a result, Europe's export of cars would stagnate. 'We will produce were the sales are. Right now, Ferrari remains the only European brand that decided to keep its production base in Europe', an advisor at a large German car company stated.[12]

In the *aircraft* industry, China has a much longer way to go, but here as well Europe will face more competition. While certainly not on par with its single-aisle Airbus variants, the C919 signals that China is rapidly moving forward. Airbus officials reckon that with small improvements in fuel efficiency, they can maintain an edge but that Chinese exports could become attractive, thanks to the lower prices and cheap export buyer's credit.[13] A senior Airbus representative estimated that his company and Boeing would continue to dominate the market during the next big wave of civilian aircraft purchases, between 2010 and 2020, but that soon afterwards, the market will also become the hunting ground of Chinese, Turkish, and Brazilian companies. 'There will be huge demand, well over 25,000 new passenger airliners during the next 20 years', he stated, 'But our profits per plane will dwindle'.[14] The European aeronautic industry also anticipates China to become a major rival in the market of military aircraft. Two experts at the European Aeronautic Defence and Space (EADS) Company foresaw that, as a consequence of reduced spending on military systems in Europe, competition for large contracts abroad would mainly take place between the United States, China, and Russia, with Europe being largely sidelined. 'Every major state wants to make its own civilian and military planes, whether it is for prestige or economic reasons. Some will do a poor job and be confined to the domestic market. Others will catch up rapidly and make life more difficult to us. China will be the first among them.'[15]

The same goes for the *pharmaceutical* business. Between 2000 and 2010, Chinese exports expanded by a meagre USD 3.8 billion compared to Europe's remarkable USD 95.7 billion growth. Much of Chinese exports were generic products or chemical components, often processed by companies from abroad. Chinese pharmaceutical companies are considered to be at the bottom of the

12 Interview on the Chinese automotive industry with advisor to German car producer, Berlin, 9 Sep. 2011.

13 Interview on the Chinese aeronautic industry with senior executive at Airbus, Singapore, 16 Jun. 2011; Interview on the Chinese aeronautic industry with senior executive at Airbus, Brussels, 19 Aug. 2011.

14 Interview on the Chinese aeronautic industry with senior executive at Airbus, Singapore, 16 Jun. 2011.

15 Interview on the Chinese aeronautic industry with executive an advisor at European Aeronautic Defence and Space, Brussels, 3 Jun. 2011.

innovation ladder.[16] Over 95% of domestically produced medicines are generic ones. There are two reasons to expect China's position in the global pharmaceutical products market to improve. On the one hand, the government weighed in with generous support for indigenous innovation and to help local firms attain Western standards. That incidents with counterfeit medicines caused serious image damage and confirmed that the problematic quality standards goes without any doubt. However, steadily, a small cluster of advanced companies has gained reputation at home and abroad. On the other hand, the various incentives for research, the appeal of the fastest growing consumer market in the world, access to cheap chemicals, and the prospect of better protection of intellectual property will continue to lure large European companies to the East.

The division of labour between China and Europe has blurred. A brief survey of three key industries in Europe – cars, aircraft, and pharmaceutical goods – learns that this trend is likely to continue. At this point, liberal optimists rush in to argue that in the globalized economy, specialization does no longer exist across industries but along the production chain. The division of labour, so to speak, has become a matter of vertical integration instead of horizontal specialization. Departing from the six-digit commodities database, I do not find evidence that this is the case. China is graduating to the status of a mature industrial nation that combines its traditional strength of assembling with the production of advanced components, the processing of raw materials, and the development and integration of new technologies. China's growing exports of various parts for the electronic and car industries show that it is doing well at all stages of the production chain. A second argument is that a lot of Chinese exports continue to be controlled by foreign companies and that revenues flow back to Europe. To be sure, China's growing exports have largely been the result of the performance of foreign investors, and it remains to be seen how fast Chinese companies will catch up. Nonetheless, the eventual profits of these European investors should not distract us from what the rise of China means to European countries. The next section will show that the interests between European companies and countries in regard to China do not always converge. A third argument is that the global market is big enough for old and new industrializing countries. The demand for passenger aircraft, for instance, will be large enough to fill the order books of Airbus, Boeing, and a possible Chinese challenger. The same goes for the car industry, where the steep upward trend in global sales is likely to be maintained – both in hybrid and traditional cars. Yet, there are signals that production continues to outpace demand

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16 R. Bate & Karen Porter, *The Problems and Potential of China's Pharmaceutical Industry* (Washington: American Enterprise Institute, 2009).

and that capacity utilization rates in several industries dwindle.[17] At times of growing demand, such gap will make competition more pressing and force companies to innovate faster. In periods of slowdown, the most probable outlook for the coming years, the expanding capacity in one part of the world cannot but affect production elsewhere. A last argument is that growing supply lowers prices, which is good for consumers, and that incomes from the services sector could compensate for eventual losses in manufacturing.

Let us look closer at European and Chinese exports of services. Between 2000 and 2010, European services exports increased by USD 354 billion, Chinese by USD 127. Europe performed particularly well in selling intellectual property, information technology, and financial services. Gains were similar in transport and construction, while Chinese exports increased more in tourism. The combined value of Chinese and European services exports in 2010 amounted to only 26.5% of their exports of goods. By any standard, services do not have the same importance in terms of trade revenues as goods. Services exports are too small to match the importance of trade in goods, and recent forays abroad by construction companies, transport firms, and Chinese banks show that this is not going to remain a European stronghold either.

3 THE BALANCE OF PAYMENTS

If a country's expanding exports lead to a trade surplus, this is expected to cause larger investment outflows. In a free market, the growing supply of capital lowers domestic interest rates and thus also the income from savings. For large capital holders, it becomes more interesting to park their money in countries with higher interest rates. Another redistributing mechanism in an open international market is that trade surpluses push up currency rates compared to countries that run a deficit. As this increases the price of exported goods, it could favour exports from other economies and, when the appreciation holds on, prompt companies to relocate their production capacity, which equally triggers an outflow of investment. So, these two rules of thumb of classic liberal economic theory

17 China has recorded low-capacity utilization rates for most basic products, like steel (around 70% in 2009 and decreasing), copper plate (58% in 2009 and decreasing), cement (78% in 2009), aluminium (67% in 2009 and decreasing), ethylene (75% in 2009 and decreasing), PVC (55% in 2009 and decreasing), silicone (50% in 2009 and decreasing), and hydrofluoric acid (70% in 2009 and decreasing). In the components industry, China has boosted its capacity in advanced product segments to a degree that utilization rates have been falling significantly in semiconductors (75% in 2009 and decreasing), printed circuits (60% and decreasing), and solar cells (43% in 2009 and decreasing). While basic household goods manufacturing has been plagued with low utilization rates – as low as 60% in case of television, refrigerators, and washing machines – since a very long time, its capacity remained limited in braches like cars.

prescribe that the balance of payment between China and the European Union must move towards equilibrium.

Are there data available to test this? The Chinese government does not provide county-wise balance of payments statistics. Eurostat does offer a detailed dataset for the balance of payments with its most important economic partners for the period between 2006 and 2010. In case of China, it covers the entire current account, but only a part of the financial account. Figures for portfolio investment, other investments, and reserve assets are not included. The first two components of the financial account are available for the Eurozone via the European Central Bank (ECB). Figures of Chinese purchases of reserve assets like government bonds are nowhere to be found, even not in the databases of national central banks. A completely accurate assessment of the balance of payments is thus not possible, but we could brush the broad picture.

Starting with the current account balance, it does not come as a surprise that Europe's deficit in trade in goods has expanded substantially: from USD 147.6 in 2006 to USD 205.7 in 2010. This caused an accumulated financial drain of USD 955.0 billion, which was not matched by the accumulated surplus in services of USD 27.0 billion – mostly from royalties and business services – and the accumulated USD 39.4 billion in investment revenues. A small current transfer deficit of USD 17.5 billion made the total current account balance to run an aggregated deficit of USD 909.5 billion. Has this been offset by large inflows in the financial account balance? To start with, the European Union's direct investments in China continued to exceed foreign direct investment flows in the other direction. Between 2006 and 2010, accumulated investments in China reached USD 40.3 billion, whereas Chinese investments in Europe were only USD 4.6 billion. That makes another 35.7 billion net outflow.

Table 1 Estimations of the Accumulated Net In- and Outflows in Different Parts of the Balance of Payments between 2006 and 2010 (Net Flows in Billion USD)

Net Outflows	*2006*	*2007*	*2008*	*2009*	*2010*	*Total*
Goods	148	197	234	171	206	955
Direct investment	5	6	11	8	5	36
Other investment	5	9	19	5	3	30
Portfolio investment	20	18	3	10	9	23

Current transfers	2	4	4	4	4	18
Net Inflows						
Reserve asset purchases	N.a.	N.a.	N.a.	N.a.	N.a.	(500)
Investment income	4	6	9	8	9	36
Services	3	4	8	8	5	27

Source: Eurostat/EU27 for current account categories and FDI, ECB/Eurozone for financial account categories and interviews for reserve asset estimations

For the other elements of the financial account balance, we have to limit us to data for the seventeen members of the Eurozone, which still represent the largest part of transactions between the European Union and China.[18] Between 2006 and 2010, the Eurozone countries invested a total of USD 30.6 billion in Chinese equity and debt securities, whereas accumulated Chinese portfolio investment in the Eurozone during that period was only USD 2.5 billion.[19] The balance of other investments – covering mostly trade credits and loans – also turned negative: accumulated European investments in this category between 2006 and 2010 amounted to USD 10.3 billion, while Chinese investments shrunk by USD 19.8 billion, forming yet another drain of USD 30.1 billion. We finally arrive at the most secretive part of the financial account balance, that is, the transfer of reserve assets. Both China and the European national banks do not officially disclose figures. However, interviews with officials from the ECB, the European Commission, and officials from two key Member States, all revealed that China had purchased for USD 450–550 billion in government bonds from member of the Eurozone between 2007 and 2010, mostly in strong economies like Germany, which equals about a quarter of the increase in public debt during that period and a quarter of the increase in Chinese foreign exchange reserves.[20]

Hence, the balance of payments has not tended towards equilibrium and the large deficit in trade in goods was not equalled by surpluses in other sectors. The only sizeable financial transfer from China to Europe concerned the government-controlled investment in official reserve assets. Between 2006 and 2010, Europe ran an accumulated net balance of payments outflow of roughly USD 500 billion, which implies that, on average, USD 100 billion of wealth

18 93% of FDI and 87% of trade.

19 Ecfin, Chinese, Save decrease stock 285 to 257 billion USD.

20 Interview on Chinese reserve assets purchases with Member State official, Brussels, 12 Sep. 2011; Interview on Chinese reserve assets purchases with Member State official (*bis*), Brussels, 12 Sep. 2011; Interview on Chinese reserve assets purchases with EU official, Brussels, 14 Sep. 2011.

seeped away to China each year. It also means that compared to China, the European Union has neither been competitive as a trading power nor attractive to Chinese companies as an investment market. Such unequal partnership inevitably gives reason for concern. However, before we assess their causes and consequences, let us put the imbalances in a correct proportion. As a share of the European gross domestic product, the net balance of payments outflows to China amounted only to 0.6%, which, formulated bluntly, seems to be a reasonable premium for a growing array of products at dropping prices, externalizing polluting industries, freeing a large number of European workers from routine labour in factory halls, and delegating the task of securing the supply of raw materials from rather perilous parts of the globe. The deficit of USD 500 accumulated over this long a period also remains very modest in comparison to the USD 1.5 trillion that the International Monetary Fund (IMF) reported to be lost by European banks in the financial crisis between 2007 and 2010.[21] In sum, the assumption that the balance of payments must tend towards equilibrium does not withstand reality in case of the Sino-European relations. Europe's deficits were dramatic, but they remained limited in comparison to its overall economic weight.

4 TWIN DISTORTIONS

The financial crisis to which I briefly referred in the previous paragraph immediately leads us to one of the main explanations for the unbalanced economic relationship between China and Europe. The crisis painfully exposed that many parts of Europe had created a virtual sense of wealth that encouraged citizens to spend more than they earned and prevented them to adjust to deteriorating economic realities, like slow productivity gains. Since the seventies, European countries rapidly built up public debt: from 37% of their gross domestic product in 1970 to 70% in 1990. Public spending helped absorb the millions of workers that were laid off in manufacturing. The establishment of the Monetary Union in 1999 only led to more internal imbalances. Germany and a few other Member States registered growing trade surpluses and saw their economies becoming more competitive, which pushed up the value of the Euro. The performance of the Euro further reduced the competitiveness of several southern Member States that mostly exported basic goods, like textile, shoes, and furniture. Had those countries been 'independent' markets, this would have led to growing unemployment, depreciating national currencies, increasing interest rates, and higher sovereign bond yields. Households and governments would be forced to spend less. At the same time, however, cheap labour and low currency rates would

21 <http://ec.europa.eu/commission_2010-2014/barnier/headlines/news/2011/07/20110720_en.htm>.

make those countries more attractive to investors and form the fundamentals for future growth.

The Eurozone prevented exactly that gradual process of adjustment to take place. As countries like Germany kept the value of the Euro up, weakening Member States could continue to lend end spend. Unemployment remained high, but governments could afford generous unemployment schemes. Manufacturing continued to lose competitiveness, but spending in the public sector and support for the citizens to buy houses still generated growth. These government policies at European Union and Member State levels formed an ideal incubator for risky financial products and adventurism in the banking sector. Between 1999 and 2007, the total volume of outstanding residential loans and the repo market in the Eurozone, for example, grew by 11% and 30% per year, while economic growth was just 3%.[22] Without this politically induced gap between the financial and real economy, neither would Europe be able to spend so much on imported goods nor would industrial production be relocated so speedily to the East.

China' pursuit of prosperity was almost the mirror image of the policies of many European countries.[23] Whereas European states expanded the public sector in the seventies and eighties, China commenced downscaling its state-owned enterprises. It ran trade deficits because it imported capital goods to lay the fundaments of its industrial power base. The export-oriented strategies that followed its take-off put a brake on household consumption. Low taxes promoted entrepreneurship, whereas taxes in several European countries became more burdensome. Layoffs in the state-owned sector kept wages low, whereas the growing public sector Europe propped up salaries. The Chinese government instructed policy banks to prioritize cheap lending to industries and infrastructure projects, while European banks were encouraged to churn out more mortgage loans for families. The ECB adhered to a strong Euro policy, whereas the People's Bank of China tried to prevent growing national wealth from levering up the Yuan. China too paid a high price for its surplus-driven growth. Families became much richer, but they benefited relatively less from China's growth. The share of household consumption in China's gross domestic product reached an absolute low of 34% in 2010. High savings and low interest rates allowed banks to invest in companies and government project that were not rewarding, creating different waves of bad loans. Overcapacity continued to make China dependent on foreign

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22 Outstanding mortgate loans by year end: EUR 2.7 trillion in 1999 and 6.1 trillion in 2007. European Central Bank (ECB), 'OCT Derevatives and Post-Trading Infrastructures' (Frankfurt: ECB, 2009), 14.

23 See, among others, B. Naughton, 'In China's Economy, the State's Hand Grows Heavier', *Current History* (September 2009): 277–283; M. Pettis, 'The Contentious Debate over China's Economic Transition', *Carnegie Policy Outlook* (25 Mar. 2011); C. Walter & F. Howie, *Red Capitalism* (Singapore: Wiley, 2011).

consumer markets. It prompted the government to keep the Yuan low and to buy sovereign bonds of Western governments, helping to keep currencies of their weakening economies afloat and to keep consumers buying 'Made-in-China' goods. In sum, Europe would never be able to develop such unequal partnership if China had not kept the Yuan so low.

Internal imbalances on both sides of the Eurasian continents grew thus in tandem and were interlinked. I do not go as far as some colleagues to claim that the artificially low Yuan and other forms of Chinese mercantilism, such as subsidies and cheap loans, caused overconsumption in Europe and forced households and governments into debt. After all, Europe's deficit-driven growth predated China's great opening-up. More accurate might be that the two economies encouraged each other in different forms of economic folly that could not but lead to painful crises of adjustment. A more important discussion is how this inevitable adjustment can unfold: the adjustment of living standards to economic reality, of earnings to productivity, and of currency rates to the creation of wealth.

5 TWIN SOLUTIONS

The first scenario is to *let the markets do their work*. Governments cannot be regulators and clients of their own system at the same time. Even if governments entertain the noble objective of promoting economic security, their policies are counterproductive in the long run. In an open market, competition is strong, but as changes in competitiveness are a gradual and diffuse process, adjustments in terms of revenues and employment also happen gradually and are easier to bear by societies. In a politically manipulated economy, governments can try to postpone or accelerate changes, but as distortions in expenditures, currency rates, balance of payments increase, states will inevitably reach turning points at which adjustment will be more drastic, painful, and destabilizing. In other words, major crises of adjustment are a return to economic reality of systems that have gone out of control because investors bought into assets whose values were determined by government priorities rather than the basic law of demand and supply. This logic requires Europe and China to deregulate their economic exchanges, to abandon currency manipulation, to stop providing government support to key industries, and to run deficits to expand the public sector. A severe period of recession would be unavoidable, but afterwards, markets would correct themselves, the Euro would devalue, wages in many European countries would plummet, and trade imbalances would become smaller. The result would be a dramatic catharsis that makes future economic growth and exchanges more durable. China would lose part of its Euro-denominated assets, but those losses would be manageable, as the Yuan quickly appreciates. Exports to Europe would decrease, but domestic sales would climb. However compelling this scenario from a liberal economic perspective, it remains political fiction. It would oblige states to admit the intrinsic long-term danger of steering markets, to dispose entirely of the idea of economic security, and even to give up some key levers that lay at the basis of statehood itself. The consequence of that is, though, that major crises of adjustment will continue to occur and destabilize relations among states. For China and Europe, it entails that the shift in the balance of economic power will cause major tensions and conflicts in their relationship.

In a second scenario, *government-controlled capital transfers* from the People's Bank of China would allow Europe to overcome its debt current crisis and China to steer clear of a major perturbation in its growth driven by export and investment in fixed assets. In other words: decaying Europe delays its painful descent, and rising China accelerates its industrialization. The end result would be a mightily rich giant in the East, but with so much of its wealth invested in European sovereign bonds that it cannot but make huge losses if the European castles of debt crumble after all. Such dead-ended track dependency is neither very likely. Chinese citizens become increasingly hostile to such transfers. So understands the government that the aspired diversification of its foreign exchange reserves should not lead to even more exposure to possible defaults or debt restructuring.

Trade wars could be the third outcome. While European governments' immediate priority is to stabilize financial markets, eventually with Chinese help, reindustrialization becomes their long-term objective. The main remedy to debt and deficits is growth, the reasoning goes, and growth can only be guaranteed by ramping up production, industrial production. Services are all nice, but without industrial output, services cannot be maintained. Furthermore, services will never get on par with goods in the balance of payments. Nevertheless, lest a social carnage leads to electoral defeat, politicians will pursue reindustrialization while limiting cuts in wages, preventing the dismantlement of the welfare state, and avoiding steep devaluations. That would mean, of course, that Europe will never be able to compete with China's cheaper products and that reindustrialization can only be pursued if it coincides with protectionism, protectionism that will almost inevitably be retaliated by China, and spirals into new trade wars. Elites in both economies, though, are very well aware of the perils of protectionism, and for Europe, it would even be difficult institutionally as decision making on such policies will be a difficult bargaining process between numerous interest groups. Europe's *liberal firewall* and China's inclination towards moderation will certainly help withstand protectionist pressure in the short term, but it remains uncertain whether they will also resist calls for protectionism if the crisis persists over a period of several years.[24] Moreover, it would not be the first time that liberal standards or the defence of fair trade is used to legitimize protectionist policies. The retreat into protectionism is thus a slow process, but a protracted episode of uncertainty could and probably will give it the time to assert itself in new policies.

The most preferable approach would be a *phased, politically coordinated deregulation*. Europe and China would consent in large temporary capital transfers via the Chinese purchase of sovereign bonds from solid countries and large purchases of European goods, of the kind agreed during the so-called buying missions of Chinese politicians. Once stability in the financial markets returns, both sides start a controlled downward correction of the Euro and an upward correction of the Yuan. As the Yuan appreciates, the losses in the value of European debt relatively decrease. Inflationary pressure would be kept in check because of strong industrial capacity, cheaper imports of food and raw materials, and the reducing surplus on the current account balance and the direct investment part of the capital account balance. At the same time, taxes and regulation on speculative financial transactions can limit the destabilizing impact of hot money. These measures would be reciprocated by a new stability pact in the Eurozone that imposes limitations on government spending of the Member States and enforces fiscal harmonization. Restructuring leads to unemployment and lower wages, but modest yet sound growth in China or other emerging markets, as well as a devaluing Euro, makes jobless people to be picked up by revitalized industries and supplying services. Such a coordinated adjustment would take time. It requires elites that are able to act with vigour and to overrule vested interests at the risk of political defeat. That is even true in one-party-state China. The fact that it took Europe enormous efforts to reach a basic consensus on financial stabilization and that Beijing has not fulfilled much of its promises to make domestic consumption the new catalyst of growth leaves this scenario to be doubtful as well. At the time of writing this paper, I had no indication that such coordination was on the agenda of high-level talk. Moreover, strengthening European industries will not be easy as most of the global production chains have been reoriented towards the East, a lot of the manufacturing sector struggles with overcapacity, and China's comparative advantages in lots of sectors have become very strong.

The previous scenarios could also fuse into the following plot: *pretend, persist, panic, and protect*. Europe and China would, in the first place, go on preaching that

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[24] With liberal firewall, I mean the combination of the following factors: (1) the diluting effect of consensus building among twenty-seven Member States with different economic interests, (2) the liberal principles enshrined in Europe's founding treaties, (3) the liberal culture of the EU bureacracy, (4) the prevailing interests of European export-oriented industries, (5) the socialization of a whole generation of decision makers, experts, and opinion leaders with moderate liberal economic values.

they need each other, that joint action is required, and that some very serious domestic reforms are required. Both sides, however, would also largely persist in their initial policies as drastic change might not be feasible politically and be discouraged by economists who claim, understandably, that reform and austerity need to be cautiously implemented, lest they lead to recession. European governments, at the same time, will scramble to China for financial support and investments. The Chinese government will nourish these expectations by making supportive statements, dispatching more business delegations, and selectively buying reserve assets from strong Member States. Yet, in the end, nothing substantially will happen. Reforms will be postponed as long as possible and Chinese investors continue to be loath to try their luck in Europe. Sooner probably than later, a major crisis of adjustment will break out and last for a long period. Panic will erupt, and prudence will make place for more populist variants of politics that will be more inclined towards protectionism.

6 CONCLUSIONS

This paper has demonstrated that liberal economic and political principles are not helpful in explaining the Sino-European relations. The proclaimed harmony of interests, built on a mutually beneficial division of labour and the redistributory effect of the balance of payments, is a fiction. Between 2000 and 2010, economic complementarity decreased and Europe's deficits on the balance of payments remained large. While the net transfer of wealth to China remained small as a part of Europe's gross domestic production, it signals that governments on both sides are distorting economic exchanges. There is no reason to believe that these policies were meant to harm each other. They were the consequence of the fixation with economic security and the fear of social instability at home, which prompted states to postpone adjustment costs and to accept imbalances that rendered a sound economic partnership impossible. Imbalances in the East and in the West are interlinked, but a coordinated and gradual adjustment remains unlikely. In the short term, the two sides will stress that they need each other and try to maintain stability, but in the long run, their initial objective of economic security will be much under pressure, to the degree even that protectionism becomes the most likely outcome. While the Sino-European relationship forms only one example, other cases could also demonstrate that as long as political constructions continue to wield influence over geographically delimitated tracts of the world economy, define interests along their borders, and influence markets – being it by pursuing industrial policies or building welfare states – they will have a tendency to violate the regulating mechanisms of the free market. For this reason, liberal economic premises cannot be relied upon as the guiding principle of international politics. At a certain stage, imbalances will just become so big that states will inevitably fail in their quest for prosperity and peace. In that sense, realism is thus a much more reliable guide than an inconsistent variant of liberalism.