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Challenge and Opportunity: China inside the WTO and EU-China Relations

December 11, 2021, marks the 20th anniversary of China's accession to the World Trade Organization (WTO). This policy brief argues that China's integration into the multilateral trading system has brought about considerable benefits for the EU, but the challenges in mutual relations now threaten to outweigh the opportunities. Without giving up on multilateralism, the EU should focus on promoting and protecting its economic openness through new and refreshed policy instruments – and the willingness to deploy them.

Smart phones, computers, integrated circuits – China's main export goods show that it has developed way beyond providing the world with cheap toys and textiles but has upgraded its technological position in global value chains. In 2019, high-tech exports made up more than 30 percent of Chinese industrial exports – far more than those of the U.S. (18.9 percent) or the EU (16.1 percent). China's accession to the World Trade Organization (WTO) on December 11, 2001, has been critical to this development. It transformed the international division of labor with a major impact not only on the world economy, but also on relations between the EU and China as two leading trade powers. In this policy brief, we briefly wrap up the role of the WTO and China's accession to it. We then focus on EU-China economic relations as well as challenges and opportunities in this increasingly complex relationship. The conclusion addresses possible policy implications for the EU's approach towards relations with China in future.

The WTO in a nutshell

The WTO was founded in 1995 as successor body to the General Agreement on Tariffs and Trade (GATT). It brought together under one roof several treaties, not only on tariffs, but also on services or intellectual property rights. This has led to a prolonged period of low tariffs for its member states. Such a stable and predictable environment is propitious for companies while paving the way for complex global production networks. On these grounds, the entire membership achieved a total increase in

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prosperity of around 855 billion U.S. dollars in the 25 years of WTO existence. This corresponds to an average gain of ca. 4.51 percent of GDP per member country according to a study on behalf of by Bertelsmann Stiftung. However, distribution among the members has been uneven, especially with regards to developing countries. Currently, the WTO is partly dysfunctional despite this overall economic success story:

1. The Doha Trade Round the WTO members started 20 years ago failed to produce the expected results in regard to further trade liberalization and resolving the issue of agricultural subsidies. Therefore, more and more WTO members have turned to bilateral and plurilateral agreements. They hope to address unresolved issues, such as subsidies and other non-tariff barriers to trade, with greater success outside the WTO framework. Bilateral approaches, however, threaten to further undermine multilateralism.
2. WTO rules were designed for market economies. The WTO therefore faces difficulties in accommodating China's state-capitalist economy. It is clear that WTO rules need an update, but the reform process has been painstakingly slow.
3. One of its most important mechanisms, the appellate body, which was designed for resolving disputes among WTO members, stopped working in November 2020. This was largely because the U.S. administration blocked the nomination of new members to the body, which has to have at least three in place to function at all.

The future of the WTO as the core of the multilateral rules-based system is therefore highly uncertain. From an economic point of view, however, a multilateral approach to global economic governance remains by far the first-best option to level the playing field and give smaller players more weight in designing international rules and reigning in larger players to abide by those rules – even though the EU, U.S. and China have shown how difficult this can be.

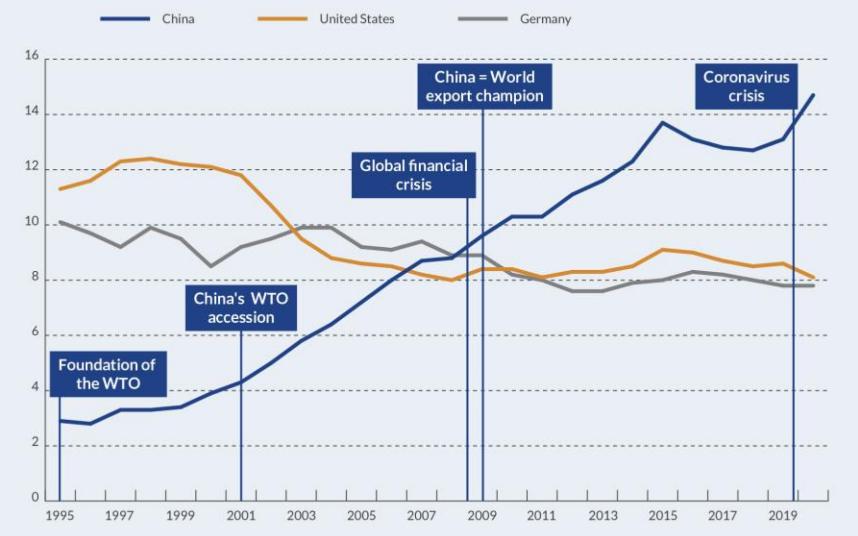
20th anniversary: China inside the WTO

It is safe to say that China with its unique economic development has played a substantial role in WTO success – but also in its current crisis. On December 11, 2001, China officially became the 143rd member of the World Trade Organization. This was preceded by lengthy negotiations. Especially the U.S., but also the EU, showed some reluctance to having a country with a very different political and economic system join an organization mainly designed by and for market economies. China therefore failed to become a founding member of the WTO in 1995, but succeeded six years later, after making – from a Chinese perspective – substantial concessions.

China's WTO membership laid an important foundation for embedding the country within the world economy and global value chains. The Chinese government fostered an export-oriented growth model based on a vast pool of low-cost labor and special conditions for foreign investors. China became the most prominent destination for foreign direct investment (FDI) and a key global production hub, the "factory of the world". This in turn intensified global economic integration and had a profound impact on the international division of labor. People in the EU and worldwide benefited from cheaper consumer goods, which spread globalization gains more broadly and increased welfare around the world. In 2009, overtaking the U.S. and Germany, China became "world export champion" (figure 1) and is today a key economic and trade partner for a large number of countries worldwide. It is no longer possible to imagine world trade and global value chains without "Made in China".

China's WTO accession also contributed to its rise as a major foreign investor (figure 2): the increasing global integration of its economy drove forward the internationalization process of Chinese firms. More and more of them started "going out" (*zouchuqu*) to look for new markets, technology and know-how – with a growing focus on developed economies, such as the EU, in the last decade. Most EU member states were at first positive about Chinese investment in their domestic markets, especially given substantial asymmetries in mutual investment relations in favor of the EU. However, in recent years, fears of a technological sell-off to China has become prevalent, strongly reflecting an increasing disillusionment about the practical implications of Chinese WTO membership.

Figure 1: **China's, Germany's and the United States' share in world exports (merchandise), 1995-2020** (in percent)



Source: WTO Stats (download of data: 10.05.2021).
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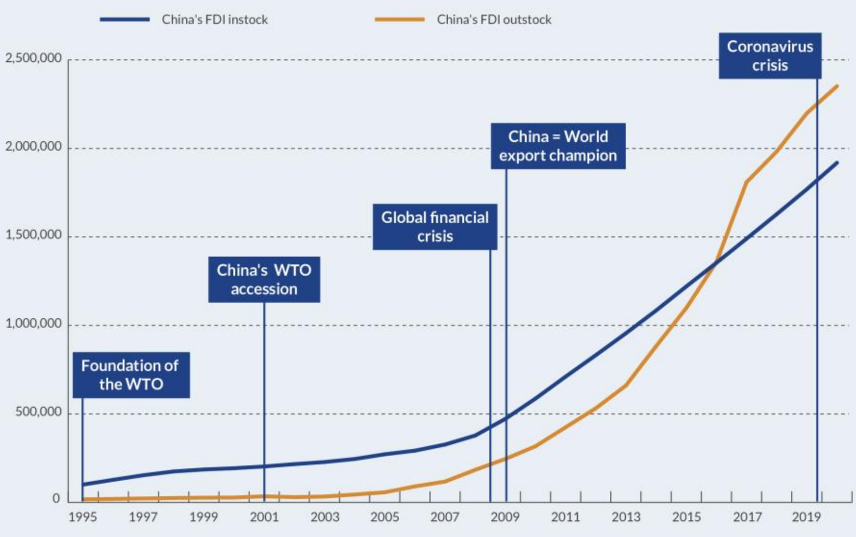
Figure 2: **China's foreign direct investment (FDI) instock and outstock, 1995-2020** (million USD)



Source: World Investment Report 2021 - Annex Tables (download of data: 16.11.2021).
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EU-China relations since China's WTO accession

China's WTO accession has undoubtedly created substantial economic gains and opportunities, especially for the EU and developed economies. However, the integration of a large non-democratic non-market economy into the multilateral rules-based system has also brought about considerable challenges and contributed to its current crisis. The EU, like other western countries, had expected convergence towards its own model from China through its WTO membership, i.e. further opening up and slowly but steadily transforming into a fully-fledged market economy, which would sooner or later also bring about a democratic transition of the political system.

In the first decade of China's membership, this process may indeed have been conceivable for some observers, with more and more market elements being introduced to the Chinese economy. But in the following decade, especially since Xi Jinping took office in 2013, it has become clear that western expectations in this regard will not be fulfilled any time soon. To the contrary, China appears to have embarked on a distinct course of divergence, actively promoting its own developmental, and thus, political model around the globe. State interference in the Chinese economy has significantly increased in recent years. So have complaints about distorted competition and unfair business practices brought about by China's state-capitalist system, not only domestically, but also overseas, e.g. through presumably state-subsidized acquisition of EU high-tech companies.

The "competition of systems" is thus back on the agenda and taking place under the very roof of the WTO. So far, the implementation of WTO principles like non-discrimination between domestic and foreign investors and reciprocity in market access – the much discussed "level playing field" – has not been achieved from the perspective of industrialized countries. This has caused considerable tensions in EU-China relations: Europe has been a leading proponent of the principle of "change through trade" and fostered close economic relations with China, while at the same time trying to keep sensitive policy issues, like human rights, separate. In 2019, however, the EU recalibrated this approach by stipulating that China is not only a partner and competitor, but also a systemic rival, adding a strong geopolitical component to its longstanding relationship with China.

Curse and blessing: Intensifying mutual trade and investment relations

Trade and investment have been at the core of EU-China relations, as both are large economic powers with vast markets offering abundant business opportunities. Even though relations were far from harmonious at the time of China's WTO accession and trade disputes, like the one on exceeded quotas for Chinese textile and clothing imports to the EU ("Bra Wars") in 2005, blew up shortly after, the fact of a 1.4 billion-strong consumer market with its vast opportunities for European businesses seemed to outweigh these challenges. This was all the more so because the assumption that WTO membership would reign in Chinese business practices that breached market-economy principles remained intact.

Trade and investment relations between the EU and China have thus increased to an unprecedented degree over the last two decades and, as figures 3 and 4 show, China's WTO accession is among the factors that have played an important role here. In 2020, China was the EU's largest trading partner, accounting for 16 percent of overall trade, 22.4 percent of EU imports and 10.5 percent of EU exports. Hidden behind the mere trade figures is moreover the fact that China plays a crucial role in the global value chains of EU companies.

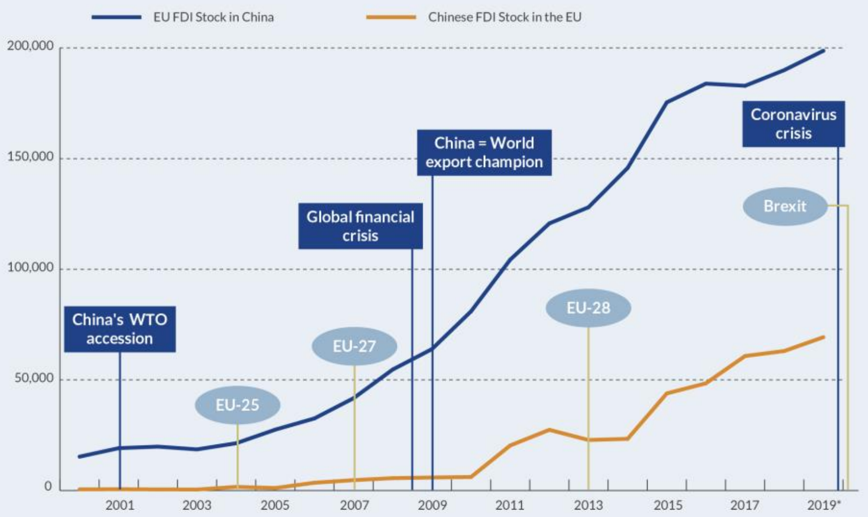
While EU-China trade relations are clearly biased towards exports from China, the reverse is true for foreign direct investment from China to the EU: Until 2019, Chinese companies invested roughly 70 billion Euro in the EU, which is only about one third of the 200 billion Euro EU companies invested in China in the same period. This makes mutual investment relations clearly asymmetrical in terms of volume. It might therefore appear surprising at first glance that Chinese investment in the EU triggered a policy process leading to the creation of the EU framework for FDI screening in 2019 – a measure that could easily be regarded as protectionist, discouraging FDI instead of staying open to much needed foreign capital inflows. This decision, however, was based on the quality of Chinese mergers and acquisitions in the EU – not greenfield investment, which critically falls outside the screening process: From an EU perspective, Chinese state-driven *acquisitions* of high-tech firms, such as Chinese Midea's takeover of German robot manufacturer Kuka in 2016, have increased rapidly since the industrial policy "Made in China 2025" was instigated in 2015. At the same time, European companies in China are still facing discrimination, prompting a growing number of complaints in recent years.

Of course, we should not forget that EU-China commercial relations have so far been a blessing for the EU economy, with export-oriented members like Germany at the head of the beneficiaries: Cost-efficient production networks, cheap consumer goods, vast business opportunities, and close links with one of the most important growth regions. The latter, however,

Figure 3: **EU-China bilateral trade in goods, 1995-2020** (million EUR)

Source: Eurostat (Download of data: 1995-2001: 12.06.2012; 2002-2020: 09.11.2021). | BertelsmannStiftung

Figure 4: **EU-China bilateral FDI stock, 2000-2019** (million EUR)



Note: 2019*=EU-27. Comparability between the data up to 2012 and from 2013 is limited due to a change in methodology. However, the data still show the overall upward trend in Chinese FDI in the EU.
Source: Eurostat (Download of data: 2000-2012: 21.07.2017; 2013-2019: 26.11.2021). | BertelsmannStiftung

may turn out to be more of a curse than a blessing in future. Commercial interdependencies are desirable from an economic perspective, since they foster the international division of labor. However, if one economy becomes too dependent upon another for certain products or segments of supply chains, this may generate a critical dependency, and one which is prone to political abuse (e.g. like the U.S. semi-conductor embargo on the Chinese telecommunications firm Huawei and China's retaliation).

China itself is inclined to use such "asymmetrical interdependencies" to exert pressure in order to achieve political goals. This adds new challenges to EU-China relations, but there remain opportunities to be seized from this complex relationship, too.

Opportunities to be seized: Saving the WTO and the planet

EU relations with China are getting less comfy. However, it is a truism that global issues need global solutions and cannot be resolved without China as a key global player. And for the EU, WTO reform and climate change mitigation clearly are at the forefront. Continuously engaging with and cajoling China could pave the way for real practical progress in these two important areas.

First, the EU has established itself as an ardent proponent of the multilateral trading system, aka the WTO, which is in dire need of "revitalization" according to a widespread consensus among its members. China is a major reason for, but also the key to reforming this 20th century organization, one not designed for non-market economies. From a Chinese perspective, it should be a desirable goal, too, to have a functioning WTO in place, operating according to stable and predictable rules. The US-China trade war has shown very clearly to Beijing how much damage circumventing the multilateral mechanism and resorting to unilateral actions instead can inflict on its economy as well as individual Chinese companies.

Since the EU and China share some common ground in regard to WTO reforms and the EU (unlike the U.S.) upholds the position that China must be included in negotiations on these reforms, this is a vital area for cooperation. China decidedly wants to be at the table when the WTO rulebook is updated. The prerequisite, however, is its willingness to make concessions on those issues that are most pressing for the developed members, such as the country's state-owned enterprises (SOEs) or market-distorting subsidies. The EU could take on a mediating role vis-à-vis China, with the EU-China joint working group on WTO reforms serving as a platform to find a common denominator. For the EU, this would also present an opportunity to promulgate its environmental agenda within the reform process.

Second, when it comes to climate change mitigation, Chinas is bound to be a natural ally for the EU anyway. The country's rapid economic rise has been accompanied by a massive exploitation of the environment and natural resources, in which foreign investment undoubtedly played a considerable role. China has thereby not only become the world's factory but also the world's largest emitter of CO2. The urgency of this problem has long been known by the Chinese government, but under Xi Jinping, it has gained significant momentum, as China has pledged to become carbon-neutral by 2060. To achieve this, a massive input of – domestic and foreign – capital and technology is necessary, e.g. in world class energy technologies, where China is still lagging behind.

The global climate conference in Glasgow (COP26), even with its otherwise mixed results, has signaled that on such a crucial topic even the U.S. and China are willing to attempt a rapprochement and work towards joint efforts. The EU could seize this favorable opportunity, too, to further push its own green agenda and act as a frontrunner by stimulating EU-US-China talks about a trilateral "climate club". The countries participating in such a club would agree on a common climate policy, for example a CO2 tax, and go on to implement it jointly. Other countries would be free to join. Such an initiative would hugely contribute to reducing global CO2 emissions and could help the US, China and the EU to enact their carbon neutrality pledges –in time to save the planet, one hopes.

Challenges ahead: Finding a fresh *modus operandi* in EU-China relations

It appears natural that the EU and China as key economic players need to work together to secure stability, prosperity and sustainable development on a global level. However, putting this cooperation into practice is full of challenges. At bottom, the EU has tried to leave out, wherever possible, political dimensions from its external economic relations for a long time, especially vis-à-vis China. While this approach seemed to have worked well in the past, it is now problematic and should alter course for two reasons.

First, important basic principles of the WTO, such as reciprocity and non-discrimination, are still not fully met by China even two decades after its accession. The EU has likely been too lax on this issue in the past and missed the right time to reign China in. Instead, tensions, for example regarding unfair competition, have been growing in recent years and sharply differing political and economic systems are at their core. The fate of the Comprehensive Agreement on Investment (CAI) proves this point: It could have eased some of these tensions but its ratification is on ice due to reciprocal sanctions, triggered by human rights violations in Xinjiang.

Second, as mentioned above, close economic interdependencies have developed into a serious political risk. The US-China trade war has sparked an era in which the political "weaponization" of such links is evolving into an increasingly common policy tool. This in turn fuels the "competition of systems" between China on the one hand and the EU and U.S. on the other, rendering EU-China relations increasingly hard to navigate.

Facing this "new normal", the EU must find a fresh *modus operandi* with China both as an important partner in some areas and a serious competitor and rival in many others. The search for this has only just begun. For the time being, the concept of "Open Strategic Autonomy" is guiding European trade policy. Retaining the capability to act is central to this strategy. Openness is pursued where a diversification of risk increases autonomy – or where openness doesn't compromise it. In turn, in areas where own capabilities and production facilities are deemed strategically necessary, the EU might resort to measures that can be viewed as protectionist or market distorting, such as investment screening, industrial policy etc. Thus, the EU has to define a fine line between the promotion of economic openness, which is one the EU's hallmarks, and its protection to prevent it from becoming a one-way street – or even a boomerang. At the same time, the competition of systems is also a competition of values. In its strategy for dealing with China, the EU therefore should be very clear which values and interests are critical and hence non-negotiable – even at certain economic costs.

In the big power game between the U.S. and China, the EU moreover must work hard to avoid being sandwiched between the two, but rather able to decide for itself how to deal with China. EU Commission President Ursula von der Leyen wants to lead a "geopolitical Commission" and the EU will need time to grow into this new and unaccustomed role. However, it is already clear right now that equidistance between the U.S. and China is not a realistic option in an increasingly open competition of systems, adding to the complexities involved from a geopolitical viewpoint.

Finally, the EU also needs to find a balance between geopolitical challenges and down-to-earth business interests, which also are promoted by the member states. On the one hand, European companies need to feel free to seize opportunities in prospective growth regions, such as Asia with China at its core. On the other hand, the danger for them is real, though, for some more than for others, to be put out of business in the long run: After Chinese competitors have upgraded technologically, e.g. thanks to the continuous transfer of foreign technology, the original creators of this know-how may find it harder and harder to compete on the Chinese market. For the EU to tackle this extremely difficult challenge head-on, the crucial question will be how to persuade business of the long-term geo-political value involved albeit at the likely cost of some short-term economic benefits.

Policy implications for the EU

20 years after its WTO accession, there still is no level playing field for foreign business in China. Instead, China has reinforced its state-capitalist system. The EU has therefore adopted a more sober and realistic perspective on China: while it remains an important partner for the EU, the dimensions of "competitor" and "rival" have gained in significance in this relationship since they were first mentioned in the EU's 2019 strategy paper on China. Recent developments, such as the increasing tensions with regard to the situation in Xinjiang, Hong Kong or Taiwan, have even brought systemic rivalry to the fore - at least from the EU's perspective.

In order to take even greater account of this new situation in the future, the EU should take a five-pronged approach in its dealing with China:

1. It may be a no brainer, but the EU needs to adopt a uniform and consistent approach towards China more urgently than ever before. Only if the EU puts its combined economic weight in the balance, will it really be able to deal with China eye to eye and to gain a say in relevant geopolitical matters in the way the current Commission is targeting.
2. Never give up on multilateralism as the first-best option in international economic relations. The key here is for the EU to keep fighting for a rebooted WTO as the cornerstone of the multilateral trading system. Getting China and the U.S. to the same table is tricky but critical. At the

same time, the EU should rein in the bilateral interests of individual member states, where these could jeopardize the overall goal of effective multilateralism.

3. Whilst the future of multilateralism remains unclear, bilateral agreements and strategic diversification of economic partners are second-best options. These are vital if the EU is to mitigate, reduce or simply avoid one-sided dependencies that might be open to political blackmailing.
4. The EU should continue to evaluate and revise its external economic policy instruments rigorously and, if necessary, adopt new ones to respond to the increasing political weaponization of economic interdependencies. An important step could be the anti-coercion instrument, which the Commission presented on December 8, 2021, and which is supposed to defend the EU and its member states against economic pressure from third countries to adopt a certain policy. However, it is important to make sure that such measures remain transparent, moderate and compatible with WTO rules.
5. Finally, and critically, the strongest instruments are of little use if they are only on paper. The EU must also be willing to actually deploy these instruments, if the need arises - and make this very clear to China.

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