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The Missing Partnership: The United States, Europe, and China's Economic Challenge

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Summary

The Trump administration considers China the gravest threat facing the United States. Yet it has largely chosen a go-it-alone approach to address this challenge, mainly because it doubts others—including the European Union—are willing to take the tough measures necessary to force China to change.

This missing partnership is a missed opportunity. The Trump administration ignores that the EU has taken tough steps toward China and must play a leading role in any diplomatic strategy that has a chance of successfully confronting Beijing. Building an effective alliance with Europe will require the two sides to solve their bilateral trade problems, navigate Brussels-member state relations, and work through existing but dormant U.S.-EU channels. All of this can be done with a bit of creativity and respect—two things that are presently missing from the equation.

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While the current U.S. administration trumpets a form of nationalism, China's leaders have been deeply nationalistic for over a century. They will not be deterred by U.S. blandishments alone from their long-term intention to Make China Great Again. Yet President Xi Jinping and his colleagues in the Chinese Communist Party (CCP) know that, even as the country's export strategy succeeded in making it the world's second-largest economy and in bringing hundreds of millions of Chinese out of poverty, it simultaneously pumped so much money into the economy as to dangerously distort it, as demonstrated most clearly by serious overcapacity in industry after industry. The CCP knows reform is needed but, scarred by the turmoil of the Cultural Revolution in the 1960s and

1970s, it seeks draconian control to manage this change (even though this may be detrimental to its goals). External threats emanating from a single "imperialist" power like the United States legitimize and amplify this need for control and the problems it causes. The only way external pressure will nudge China's leaders toward reform is if it comes from a broad coalition of countries—including developing ones like India, South Africa, and Brazil—that argue that the distortions in China's economy harm them as well.

The EU is as keenly interested as the United States in China—its third-largest export market—and would like to coordinate its strategy with Washington. While its export interests long moderated the EU's willingness to speak out against China, that reserve began to loosen in 2007 when the trade commissioner argued China was playing the EU and United States against each other. More recently, China's increasingly aggressive posture on the coronavirus pandemic and toward Hong Kong and the Uighurs in Xinjiang may have hardened the EU stance, as demonstrated by its refusal to agree a "joint strategy" with China at their June 2020 summit. But it had begun toughening its economic policy toward China much earlier, with its WTO cases on auto parts and rare earths, filed with the United States in 2011–2012, as well as its debates over Chinese solar-panel dumping in 2013–2014.

In part due to the latter case, the European Commission set out in 2017 why it could and would not treat China as a market economy: the heavy hand of the CCP and the state, the weight of state-owned and -controlled enterprises in the economy, and the rampant use of subsidies and other distortions in the economy all necessitate a firm application of anti-dumping and countervailing duties. Indeed, in June, the EU imposed such duties on two companies in Egypt because of the subsidies their parent firms receive in China—a step that goes further than U.S. practice.

That same thinking is leading the EU to restrict direct and indirect access by Chinese firms to the EU's government-procurement market, as well as their

ability to invest in Europe as the European Commission considers new measures to restrain the anticompetitive effects of acquisitions by foreign firms that are supported by government subsidies. This would significantly strengthen the recently adopted EU measures to screen foreign acquisitions on national-security grounds, taken explicitly with a view to China's efforts to acquire European technology. The EU, like the United States, opposes such efforts, and has sought to tighten EU export-control laws and to constrain the ability of member states to adopt Huawei 5G technology. The EU has filed a WTO complaint against China for forcing technology transfers as a precondition to foreign investment. It has also cooperated with the United States and Japan to devise new rules against industrial subsidies and other WTO disciplines to level the playing field against China. Sharing U.S. concerns over the spread of Chinese influence, the EU seeks to counter China's Belt and Road Initiative with its own Connectivity Strategy for Central Asia.

All of this shows that the EU can and should be a partner to the United States in efforts to bring real change to the Chinese economy. With Japan, the EU will be critical to creating the broad coalition required to give weight to foreign pressure on China. But to

be true partners, the United States and the EU have to rebuild trust, resolve tensions between them, and reintroduce strategic cooperation into their relationship. The first requires U.S. recommitment to the rule of law, a sine qua non for the EU, which is itself based on treaty. The second requires give-and-take from both sides. The United States must withdraw "national security" tariffs it has (wrongly) levied and threatened upon the EU, while the EU needs to step back from actual and proposed digital taxes and climate tariffs. Both should work on creatively approaching a larger bilateral trade agreement, in particular by agreeing to address food safety and other regulatory issues outside the context of trade negotiations. The third step, a more strategic approach, can begin with the reinvigoration of the Transatlantic Economic Council as originally envisioned during Germany's presidency of the Council of the EU in 2007.

Europe and the EU are ready to work with the United States, if the latter can work with a constructive vision of China inside the rule of law. Add that to a bit of creativity, mutual respect, and diplomacy, and the missing transatlantic partnership on China may yet be built.

Introduction

China's growing economic might presents a serious challenge for the United States. Not because China wishes to supplant the United States as the world's preeminent power, but because the tools it uses to achieve this goal—including massive economic distortions that lead to serious over-capacity and technology theft that has been going on for a long time—have major consequences for the United States and the rest of the world.

The Trump administration has had some success in forcing change on China, but its go-it-alone approach will not reach the distortions in China's economy that cause the problem. Nor can the United States alone stop the leakage of key technologies that help develop China's military capabilities.

The United States needs allies to address this challenge. The European Union and its member states would like to work more closely with Washington on this because China's policies have harmful consequences for them too. But a real partnership is missing, in part because the U.S. government in general thinks the EU (and others) will not be tough enough, in part because the Trump administration's belligerence and lack of consultation make the battle with Beijing too bilateral, and in part because of the animosity it often evinces toward the EU. When France's President Emmanuel Macron suggested to Trump in 2018 that the United States work with Europe on China, the latter replied that "The EU is just as bad as China; we're coming for you guys as soon as we have a trade deal with Beijing."¹

This missing partnership is a missed opportunity, based on a U.S. misappreciation of EU policy and underappreciation of the EU's possible contributions. EU policy toward China continues to toughen, as it has for some time, not least because of China's aggressive tone in the wake of coronavirus and its imposition of a new national security law on Hong Kong. The EU's efforts in working with the United States and Japan

to devise World Trade Organization (WTO) rules to constrain China's subsidies, state-owned enterprises (SOEs), and intellectual property abuse are fairly well known, as is its work to tighten security controls on technology exports and Chinese investments in Europe. More recently the EU has gone further than the United States by levying duties on exports from Chinese firms based in Egypt for subsidies received in China. It is now contemplating new measures to prevent Chinese subsidies from giving Chinese firms an unfair advantage in acquiring European ones or from participating in EU government contracts. Even more important, the EU will be essential to rallying the broad diplomatic coalition that will be needed for the outside world to impact Beijing's domestic economic policies.

The United States' neglect of the EU as an ally on China can and should be changed. This paper describes where and how it could work better with its European partners to press China to correct its internal imbalances and the problems they cause for the global community, while more effectively addressing potentially destabilizing exports of certain dual-use technologies to the Chinese military. It begins with a description of EU-China trade and investment flows in the perspective of the U.S.-EU and U.S.-China relationships. It then provides an overview of Chinese economic policies and developments and the problems they cause internally and externally. The paper then recaps the U.S. and EU responses to these, with more background on the EU's sometimes tortured debates about its relationship with China. To identify where and how U.S. and EU positions align or differ, it then looks in detail at the EU position on economic policy issues of concern to the United States, including:

- China's general economic policy,
- state-owned enterprises,
- subsidies and over capacity,
- trade and market access,
- government procurement,
- investment liberalization,
- intellectual property protection,
- emerging technologies and 5G,
- WTO rules,

¹ Matt Korade and Elise Labott, Trump Told Macron EU Worse than China on Trade, CNN, June 11, 2018.

- the Belt and Road Initiative, and
- currency manipulation.

The paper concludes by laying out an approach to building an effective alliance between the United States and the EU, including by addressing current transatlantic trade tensions, managing Brussels-member state dynamics, and working through existing but dormant U.S.-EU institutions and channels.

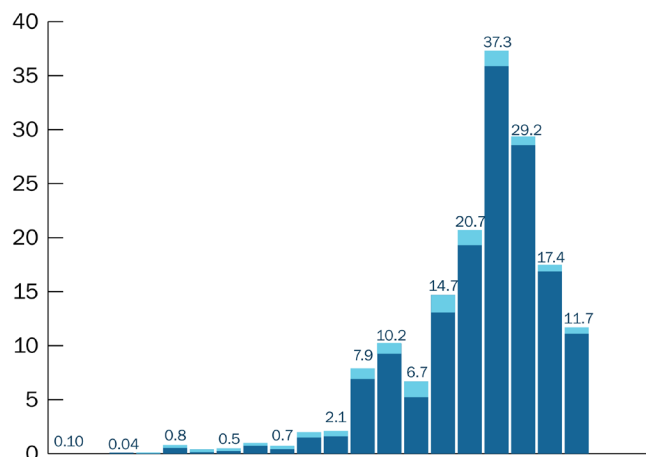
It will not be easy for the United States and the EU to work together on China. They have substantive and tactical differences. But it can be done with a bit of creativity, respect, and diplomacy. Such an alliance would have a chance to nudge China to become a “responsible global citizen.” Without one, China may still eventually come to that point, but the damage to the global economy in the meantime will be much greater.

The EU-China Economic Relationship in Perspective

The European Union and its 27 member states have an immense trading relationship with China, which is its second-largest trading partner (after the United States), its largest source of imports, and its third-largest export market (after the United States and the United Kingdom). The importance of the trading relationship is mutual—the EU is China’s largest trading partner, its second-biggest export market (after the United States), and its largest supplier. Total trade in goods and services in 2019 was about €640 billion (\$696 billion), equivalent to about 4.5 percent of EU GDP. The vast majority of that trade was in goods, as services trade accounts for only about €80 billion.²

EU exports of goods to China in 2019 were about €198 billion (\$215 billion), or 1.5 percent of EU GDP, having grown nearly 10 percent per year over the past decade. Germany accounts for just over half of total EU exports to China, followed by France at 11 percent. The vast majority of EU exports (92 percent) are

Figure 1. Chinese Foreign Direct Investment Flows into the European Union, 2000-2019



Source: Agatha Kratz, Mikko Huotari, Thilo Hanemann, and Rebecca Arcesati, *Chinese FDI in Europe: 2019 Update*, Mercator Institute for China Studies, April 8, 2020.

industrial products, including machinery and appliances (33 percent), transport equipment (21 percent), chemicals (12 percent), and instruments (7 percent). EU imports of goods were €362 billion (\$393 billion) in 2019, just over half in machinery and components, followed by textiles, apparel, and footwear (13 percent), and miscellaneous products (8 percent). The EU, like the United States, runs a substantial trade deficit with China, at €163 billion (\$177 billion) in 2019.

In contrast to the huge volumes of bilateral trade, direct investment plays a relatively small part in the EU-China economic relationship. Investment flows were essentially from Europe to China for the first decade and a half of this century, but Chinese investment in Europe shot up in 2014–16, mainly through mega-acquisitions of such key firms as Pirelli and Syngenta (tires and chemicals) by ChinaChem, and Volvo (autos) by Geely, which more recently also acquired a 9.6 percent share in Daimler. China’s acquisition spree has moderated over the past three years, as the authorities in Beijing have clamped down on outward capital flows.

European Commission data indicates that as of the end of 2018, EU-27 firms had €175.3 billion (\$190.5 billion) of direct investment in China, compared to

² All trade data from European Commission Directorate General for Trade, [European Union, Trade in Goods with China](#) May 8, 2020. Euro data converted to U.S. dollars at € 0.92=\$1.00.

€59 billion (\$64 billion) of Chinese investment in the European Union.

That last figure, however, likely understates Chinese investment in the EU.³ According to a Bloomberg analysis in 2018, “China had bought or invested in assets [in Europe] amounting to at least \$318 billion over the past ten years,” although this includes the United Kingdom and announced (but not necessarily completed) deals as well as equity investments.⁴ Focusing on completed transactions, the Rhodium Group and the Mercator Institute for China Studies (MERICS) showed in an April 2020 study a total of about €113 billion of Chinese FDI in the EU-27 as of the end of 2019, concentrated mainly in Germany (€22.7 billion), Italy (€15.9 billion), France (€14.4 billion), Finland (€12.0 billion), the Netherlands (€10.2 billion), Portugal (€6.0 billion) and Spain (€4.6 billion). This includes an inflow of €11.7 billion in 2019, down significantly from a €37 billion peak in 2016.⁵ A 2019 European Commission staff working document substantiates this, noting that Chinese firms controlled some 28,000 European firms at the end of 2016, representing nearly 2 percent of all corporate assets in Europe.⁶

Putting Things in Perspective

The United States, the European Union, and China are the world’s three largest economies, and are all about the same size with GDP of about \$15 trillion, where the EU-28 GDP sometimes exceeded that of the United States and where China’s GDP is larger than that of both the United States and the EU when using

purchasing power parity data. It is natural, then, that the U.S.-China and EU-China economic relationships should be on the same orders of magnitude—while the EU accounts for 13.5 percent of China’s total trade in goods, the United States is right behind at 12 percent, and may overtake the EU when services are added.

As large as United States’ and EU’s trade with China is, however, their respective economic relations with it pale in comparison to their relationship with one another. The U.S.-EU economic relationship is unique in that it is driven by investment. EU-27 firms have invested nearly \$2 trillion in the United States, while U.S. firms have \$2.5 trillion of direct investment in the EU-27. Indeed, according to the European Commission staff working document mentioned above, U.S. companies owned over 20 percent of the total assets of all EU-28 firms. These investments drive \$1.4 trillion in bilateral trade flows, half of which are intra-company. The sales generated by those investments reach nearly \$6 trillion, a figure that is further dwarfed by the financial flows between the two areas, many times counterpart financial flows with China. While China is important to the EU economy, the United States is and will remain far more so for years to come.

The Chinese Economy: Addiction to Growth and Its External Consequences

China’s leaders have dreamt about restoring the country’s “rightful” place in the world since Kang Youwei and Liang Qichao helped instigate the (failed) Hundred Days’ Reform in 1898. Then, for the first time, a Chinese emperor explicitly accepted that the Middle Kingdom needed to change and acquire Western technology or it would remain a vassal of foreign powers.

The Chinese Communist Party (CCP) that has ruled China since 1949 is no different; the disasters of Mao Zedong’s 1958–60 Great Leap Forward and the 1967–74 Cultural Revolution were motivated by the same ambition, which can be described as to “Make China Great Again.” Deng Xiaoping’s reorientation of the country in 1978 toward gaining strength through engagement with the outside world makes him an heir of Kang, who would surely have approved Deng’s

3 John Seaman, Mikko Huotari and Miguel Otero-Iglesias, eds, [Chinese Investment in Europe: A Country-Level Approach](#), European Think Tank Network on China, December 2017; see especially pp. 21–25 for a discussion on different databases.

4 Andre Tartar, Mira Rojanasakul and Jeremy Scott Diamond, [How China is Buying Its Way into Europe](#), Bloomberg, April 23, 2018.

5 Agatha Kratz, Mikko Huotari, Thilo Hanemann, and Rebecca Arcesati, [Chinese FDI in Europe: 2019 Update](#), Mercator Institute for China Studies, April 8, 2020.

6 European Commission, [Foreign Investment in the European Union](#), March 13, 2019.

Brexit and the EU Economic Relationship with China and the United States

The United Kingdom's leaving the European Union on January 31 will have a deep impact on the U.S.-EU-China triangle, the exact consequences of which cannot yet be known. The removal of the second-largest economy from the EU radically changes EU-China and EU-U.S. statistics; for instance, pushing China to third place as an EU export market, behind the United Kingdom. The impact on investment, and particularly the U.S.-EU investment relationship, is even more marked, as the United Kingdom was destination for nearly a quarter (\$727 billion) of U.S. investment in the EU-28. The disruption to U.S. interests from Brexit will be significant, even if the EU and United Kingdom conclude the best possible free trade agreement, for the latter had a significant influence on EU policy, including guiding EU policy toward China.

Table 1. EU-27 and EU-28 Trade and Investment with the U.S. and China (\$ billion)

	EU Goods Exports to China	EU Goods Imports from China	Chinese FDI in EU (2019)	EU Goods Exports to U.S.	EU Goods Imports from U.S.	U.S. FDI in EU
EU-28	245.7	508.7	163.9	466.3	346.5	3,270
EU-27	218.2	446.3	113.6	400.4	283.2	2,512

Sources: For EU trade, World Bank, *World Integrated Trade Solution (WITS) Database*, accessed May 10, 2020; for EU-China FDI, Seaman et al., *Chinese Investment in Europe and for U.S.-EU FDI*, U.S. Bureau of Economic Analysis, *U.S. Foreign Direct Position Abroad, Direct Investment by Country and Industry 2018*, July 24, 2019. See also European Commission, *DG Trade Statistical Guide*, July 2019, 64, which compares global EU trade for 2017–18, with the United Kingdom and without.

adage that “It doesn’t matter if a cat is black or white, as long as it catches mice.”

And, just as Kang admired Japan for assimilating Western technology (Japan’s defeat of China in their 1894–95 war was the proximate cause for the Hundred Days’ Reform), Deng and his successors looked to the success of Japan, Taiwan and South Korea in using an export-led model to build their economies between 1960 and 1990. As with those “dragons,” China’s export-oriented model entailed a focus on manufactured goods, significant suppression of domestic consumption, and government and CCP direction of large enterprises.

The desire to “Make China Great Again” applies as well to Xi Jinping, who became head of the CCP as well as head of state in 2012–13. He is the scion of a prominent first-generation CCP leader, Xi Zhongxun, who fought with Mao against the Japanese and the Nationalists before 1949 and who held major positions in the government in the 1950s and 1960s.

But Xi gained power at a different time in China’s striving toward this goal. Its adaptation of the export-oriented model of growth was cemented with its accession to the WTO in 2001, following a U.S. Congress decision to grant it Permanent Normal Trade Relationship (PNTR) status the year before. That model succeeded, as hundreds of millions of Chinese moved from the countryside into the industrial labor force, production and exports soared, education and health improved, and China became one of the world’s largest economies.

But, as had been the case with Japan and Taiwan in the 1980s, the Chinese model produced large current account surpluses (reflecting in part repressed domestic demand and high savings) that resulted in huge financial inflows that need to be balanced by capital outflows. In response, Japanese investors bought the Rockefeller Center and golf courses; the Chinese government bought U.S. Treasury bonds, but at nowhere near the scale needed to offset the

money pouring into its economy.⁷ This easy money and excess savings flowed into a banking and political system geared toward building more factories for more exports, leading to massive over-investment not just by SOEs and not just in steel, but by all players in multiple sectors (including heavy construction and agricultural equipment, electronics and real estate).

The dangers of “over-heated investment, as well as excessive credit supply and liquidity, and surplus in foreign trade and international payments” were described by Premier Wen Jiabao in 2007, as he acknowledged the “structural problems in China’s economy which cause unsteady, unbalanced, uncoordinated and unsustainable development.”⁸ To address these four imbalances, Xi announced a sweeping set of reforms at the Third Party Plenum in 2013,⁹ which were intended to help China shift from export- and investment-driven growth to domestic consumption and savings absorption, from manufacturing to services, and from imported technology to indigenous innovation, all on a more environmentally sustainable path.¹⁰

7 China’s financial outflows arguably fed the U.S. housing boom that eventually led to the 2008–09 global financial crisis.

8 Consulate General of the People’s Republic of China in San Francisco, Premier Wen Jiabao’s Press Conference, March 17, 2007. Wen went on to say: “Unsteady development means overheated investment, as well as excessive credit supply and liquidity, and surplus in foreign trade and international payments. Unbalanced development means uneven development between urban and rural areas, between different regions, and between economic and social development. Uncoordinated development means that there is lack of proper balance between the primary, secondary and tertiary sectors and between investment and consumption. Economic growth is mainly driven by investment and export. Unsustainable development means that we have not done well in saving energy and resources and protecting the environment. All these are pressing problems facing us, which require long-term efforts to resolve.”

9 China Daily, [Xi Explains China’s Reform Plan](#), November 16, 2013, and associated articles; for an easy summary of the reforms, see Lydia Guo, [China Reform Plan: In Summary](#), Financial Times, November 17, 2013.

10 See also Li Keqiang, [Address on the Current Economy at the 16th National Congress of the Chinese Trade Unions, October 21, 2013](#), November 15, 2013, as well as the writings of former Morgan Stanley Asia Chairman Stephen Roach, including [China’s Turning Point](#), Project Syndicate, February 24, 2011.

China has made some progress in its reform efforts.¹¹ Certain competition laws have been improved, as has the ease of doing business (at least for Chinese companies); various SOE reforms have been announced; interest rates have been liberalized and bank lending rates more market driven; foreign participation in capital markets, while minuscule, is growing; tariff rates have been reduced from more than 9 to about 7 percent; and imports for final consumption have been increasing.

In part as a result, consumption and even consumerism are growing, especially in the cities, and services now contribute nearly 50 percent to China’s GDP. Between 2015 and 2018, domestic consumption contributed more than 60 percent of GDP growth, with the importance of investment gradually declining.¹² More important for the rest of the world, China’s current account balance has declined dramatically from its peak of 10 percent of GDP in 2008 to near balance at 0.4 percent in 2018. Although it rose again to 1.4 percent of GDP in 2019, the longer-term decline reflects such structural factors as a significant shift from savings to consumption (the national savings rate remains abnormally high, at about 45 percent of GDP); a decline in fixed asset and real-estate investment; the difficulty of increasing China’s share of global markets, now at 17 percent for manufactured goods; a decline in imports of intermediate products as China moves up the value chain; and a huge increase in outbound tourism.¹³

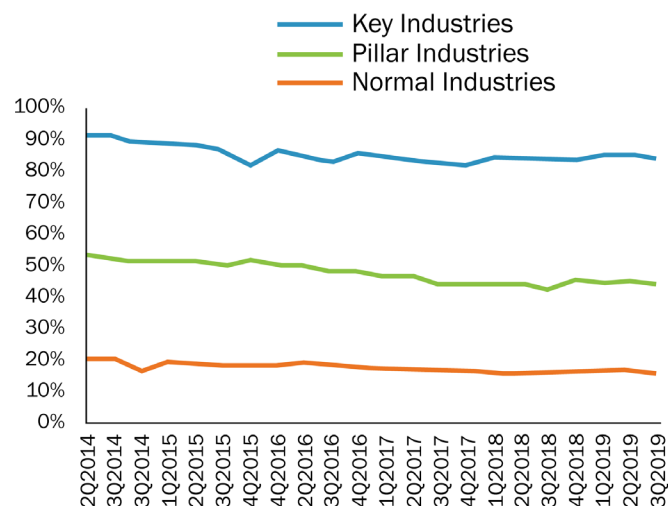
Yet reform is halting and the imbalances persist, as do their consequences, for China and for the rest of the world. SOEs continue to dominate key and pillar industries (defense, utilities, and transport in the former case; autos, chemicals, electronics, machinery, and steel in the latter). There have been numerous

11 See the tracking by the Asia Society Policy Institute and Rhodium Group of ten areas of reform as laid out at the 2013 Third Plenum, [China Dashboard, March 2020 Update](#), March 2020.

12 Jonathan Woetzel et al, [China and the World: Inside the Dynamics of a Changing Relationship](#), McKinsey Global Institute, July 1, 2019.

13 International Monetary Fund, [People’s Republic of China: Selected Issues](#), August 2019.

Figure 2: China's State-Owned Enterprises and Key Industries



Source: Asia Society Policy Institute and Rhodium Group, *China Dashboard*, March 2020 Update, March 2020.

instances of backsliding on reform efforts, including increased CPP intervention in SOEs even as they are meant to be more “commercial.”¹⁴

Further, new bank lending (mainly to SOEs) hit a record \$2.4 trillion in 2019, as China’s Central Bank “eased policy to support the world’s second-largest economy hobbled by weak global demand and the Sino-U.S. trade war.”¹⁵ And this is after years of easy money-induced credit expansion throughout the economy. Despite the bout of deleveraging after 2016 (which hit mainly the shadow financial system used primarily by private enterprise), total bank assets have quadrupled since 2007, and now stand at \$41 trillion, three times China’s GDP and nearly half the value of total global output.¹⁶

Much of this has gone into building ever more capacity in a variety of sectors, including in particular

those higher-tech areas identified in the 2015 Made in China 2025 plan: e-vehicles, solar, batteries, robotics, aircraft, semiconductors, and AI. China, for instance, has over 400 new-energy vehicle (NEV) producers, churning out 1.2 million cars a year (the world’s largest production), an untenable average of about 3,000 vehicles per manufacturer.¹⁷ For a variety of reasons, not least the need for European auto manufacturers to meet the EU’s new stringent emissions requirements, China’s excess NEV capacity is likely to come onto international markets soon, a story likely to be repeated in the other industries.¹⁸

The Chinese government and the CCP know this is a problem, but they are not sure how to address it. Not having an indirect market-based pricing approach to help allocate resources efficiently, China relies on administrative mechanisms. But the continued over-capacity demonstrates this does not work well.

The coronavirus pandemic, which slammed the Chinese economy (year-on-year GDP shrank by 6.8 percent in the first quarter of 2020), will not make reform easier. The debt overhang makes it unlikely that the government will be able to stimulate the economy as it did after the 2008–09 financial crisis, especially as companies already face \$2 trillion in debt-service payments;¹⁹ bank balance sheets are weighed down by non-performing loans, including from SOEs and regional governments (an even greater problem for the smaller banks that private-sector firms rely on); household debt, tied largely to mortgages, will constrain consumption; and export demand is likely to remain weak.

How China will recover, how that recovery is synchronized or not with the global economy, and

14 Asia Society Policy Institute and Rhodium Group, [China Dashboard, March 2020 Update](#), March 2020.

15 Judy Hua and Kevin Yao, [China’s New Bank Loans Hit Record in 2019, More Stimulus Expected](#), Reuters, January 16, 2020.

16 Logan Wright and Daniel Rosen, [Chinese Credit Stimulus: Yesterday’s Solution, Not Today’s](#), Rhodium Group, March 24, 2020.

17 Scott Kennedy, “Touching the Elephant: Explaining Patterns of China’s Innovation,” in Scott Kennedy (ed.), *China’s Uneven High-Tech Drive: Implications for the United States*, Center for Strategic and International Studies, February 2020, p. 4.

18 Tom Hancock, [Global Automakers Seek to Make China Electric Vehicle Export Hub](#), Financial Times, April 22, 2019.

19 Robert Delaney, [Economic Havoc Wreaked by Coronavirus Has Likely Throttled U.S.-China Trade Deal, Experts Say](#), South China Morning Post, April 15, 2020.

what that will mean for its imbalances and reform remain open questions. Xi and China's leadership know deep structural reform is likely the only real solution to regaining long-term sustainable growth, albeit at rates below 6 percent. But they fear the layoffs, bankruptcies, instability, and possible resentment that could cause, including among the hundreds of millions of migrant workers who may lack the right to access public services in bigger cities.²⁰

Whether increasing CCP control can do a better job than market signals in developing a strong China is highly debatable.

For Xi, whose father was purged and imprisoned during the Cultural Revolution and who himself was punished during it, such political instability must be avoided at all costs. To some extent, given modern China's tumultuous history, this is understandable. But the steps Xi has taken to forestall the instability reforms can bring are unlikely to have the desired effect. These steps include constitutional changes that would permit him to remain president for life; elevation of his "thought" to those of Mao and Deng; stifling of dissent and criticism of government policies through a free press; an anticorruption movement that in principle is good but in practice lands many normal businessmen and political opponents in jail; strengthening of the CCP's role in the decision-making of every company, including Chinese private and other foreign-owned firms; and the institutionalization of a surveillance state (including the social credit system) to enforce CCP power.

All these moves can—for a time—promote the illusion of stability. But whether increasing CCP control can do a better job than market signals in developing a strong China is highly debatable.

And the much more aggressive international stance China has adopted recently, in particular in the face of criticism of its role in the coronavirus pandemic, certainly does nothing to help the cause of "Making China Great Again." China's military assertiveness in the East and South China Seas, its imposition of a national security law on Hong Kong in contravention to its "One Country, Two Systems" promises, and its heightened saber-rattling against Taiwan as the 100th anniversary of the founding of the CCP approaches in 2021 are all likely to generate increased opposition to China worldwide, to the detriment of its ambitions.

The Tough U.S. Response

The Trump administration's response to the bilateral deficit with the Chinese export juggernaut has included a huge increase in anti-dumping and counter-vailing duties (AD/CVD) cases, "national security" tariffs on steel and aluminum driven largely by claims of China's overcapacity in these areas, and the April 2018 Section 301 decision by the U.S. Trade Representative (USTR) to place 25 percent tariffs on \$50 billion of imports from China due to its forced technology-transfer practices. In response to China's counter-moves, this last amount was subsequently ratcheted up by \$200 billion in September 2018 (initially at a 10 percent rate, increased to 25 percent in May 2019) and then \$112 billion in September 2019 at 15 percent), with a lot of additional tariffs threatened, then delayed and/or withdrawn.

The Phase One deal between the United States and China signed in February appeared to have calmed the tariff war between the two sides, although it may reignite over disputes arising from China's role in the coronavirus pandemic.

Europe initially sighed with relief at the lessening of trade tensions between the United States and China, and welcomed many aspects of the deal (especially as they related to promised changes in Chinese law on intellectual property protections and conditioning investments on technology transfer). However, it is deeply worried about the trade distortion the deal could bring given the requirement that China

²⁰ Dexter Roberts, [Don't Count on China to Lift the Global Economy – A Vast Rural Underclass is Dragging Down Growth](#), Foreign Affairs, April 8, 2020.

purchase an additional \$200 billion of certain U.S. agricultural products, energy, manufactured goods, and services (a requirement that is closer to \$240 billion as the required increase is over 2017, when U.S. exports in 2019 were lower.)²¹ The IMF was already worried in the summer of 2019 that a potential U.S.-China deal could have trade diversion effects, noting that the EU (and Germany) in particular could lose up to \$80 billion of export sales, although that estimate was based on the assumption that the United States would seek to close its trade deficit with China.²²

The Tortured European Debate

The repercussions of the Phase One agreement on the European Union, and particularly Germany, matter. For years, Europe had refused to join the United States in complaints about China's trade behavior as it had not wanted to be seen as ganging up on Beijing. While the echoes of this sentiment can still be heard in Brussels and other European capitals today, they are muted because Europe now generally shares the United States' concerns.

Things began to change with Chancellor Angela Merkel, who came to Washington at the beginning of Germany's 2007 presidency of the European Council to argue for a U.S.-EU free trade agreement to counter the growing challenge from China.²³ The George W. Bush administration rejected this, in part because it was concerned about the impact on the WTO Doha negotiations. It offered instead the creation of the Transatlantic Economic Council (TEC). The first meeting of the TEC, in November 2007, for the first time launched serious transatlantic cooperation on China, in part as the administration took notice of a hard-hitting letter from the EU trade commissioner to the president of the European Commission, which

railed at the lack of market reciprocity in China and argued that the country had for too long succeeded in playing the EU and the United States against one another.²⁴ At the TEC meeting, a dozen U.S. cabinet secretaries and EU commissioners discussed China, leading to a series of meetings over the next year between a host of U.S. agencies and directorates-general of the European Commission. The collaboration that was established arguably led to the the United States and the EU filing jointly a WTO case against China on auto parts in 2010, and to the United States, EU, and Japan doing so against China's restrictions on rare-earths exports in 2012.

Subsequently, the U.S. and EU trade agendas were taken over by the negotiations on the Trans-Pacific Partnership (TPP), the free trade agreement between the United States and 11 other Pacific Basin countries, intended in part to pressure China to reform, and the Transatlantic Trade and Investment Partnership (TTIP) between the United States and the EU. Even so, the EU's position on China was hardening. This came to an initial head in the agonizing and bitter debate about EU AD/CVD proceedings against Chinese solar panels, wafers and modules in 2012–13. While the EU duties imposed were reduced and eventually eliminated in 2018, the solar-panel dispute set the stage for the next battle—China's increasingly strident demands that the EU give it Market Economy Status (MES), which would weaken the EU's ability to wield its AD/CVD trade-defense instruments against China.

The 2014–2019 European Commission had to contend with the MES question even as its relations with the United States were souring after the Trump administration threw TTIP out the window in 2017 and cited national security as grounds to impose prohibitive duties on some \$5 billion of EU steel and aluminum exports the next year.

The EU, with Japan, decided early on to use mutual antipathy against China's aggressive export tactics to find common ground with the Trump administra-

21 Chad Bown, [Unappreciated Hazards of the US-China Phase One Deal](#), Peterson Institute of International Economics, January 21, 2020.

22 International Monetary Fund, [People's Republic of China: Selected Issues](#), August 2019.

23 Based on the author's experience as head of the State Department's Office of European and Regional Affairs in 2004–2007.

24 BBC News, [Mandelson Warning on China Trade](#), October 17, 2007. The author has seen the text of the letter.

tion. One part of this was to resolve the MES issue via reform of EU trade-defense instruments. This allowed the EU to eliminate its formal WTO reservation against China as a non-market economy, but then to effectively reimplement it with a hard-hitting report (released just before Christmas 2017) that demonstrated China did not merit market economy treatment in EU AD/CVD proceedings given “significant distortions” in the economy.²⁵ This European Commission staff working document foreshadowed the March 2018 USTR Section 301 report that led to the U.S.-China trade war,²⁶ including with its in-depth discussion of the state’s role in the Chinese economy; the privileged position of SOEs, especially in financing, land, energy prices, and other factors of production; the closed public procurement market; restrictions on foreign investment that force technology transfer; and overcapacity in a number of key industries. As the second part, EU Trade Commissioner Cecilia Malmström met with U.S. Trade Representative Robert Lighthizer and Japanese Trade Minister Hiroshige Seko on the margins of the December 2017 WTO Ministerial Conference in Buenos Aires to launch trilateral efforts to build a “level playing field” to develop disciplines on industrial subsidies and forced technology transfer, which led to agreement on certain rules in January. (These and other EU steps in response to China—including export controls, investment screening, 5G, technology transfer, and the Belt and Road Initiative—are discussed in more detail below.)

More prominently, just before the April 2019 EU-China summit, the European Commission and the European External Action Service (EEAS) published a new China strategy which for the first time explicitly labeled China a “systemic rival” (as well as a negotiating partner in some areas and an economic

competitor in others, especially technology).²⁷ European heads of state and government in the European Council supported this new approach, facilitating the “realistic, assertive and multi-faceted” EU approach to the summit the strategy had recommended. This led to Chinese agreement to deepen discussions on state aid, competition, WTO reform (including industrial subsidies) and forced technology transfer, as well as accelerating negotiations toward a bilateral investment treaty.

The new European Commission under President Ursula von der Leyen that came into office on December 1, 2019, has continued this assertive approach to China.

The new European Commission under President Ursula von der Leyen that came into office on December 1, 2019, has continued this assertive approach to China. It has been supported by the European business sector, which in February issued a report titled *The EU and China: Addressing the Systemic Challenge - A Comprehensive EU Strategy to Rebalance the Relationship with China*.²⁸ Trade Commissioner Phil Hogan welcomed the report, noting among other things that “the lack of a level playing field is all too often handicapping our economic operators from competing with China on an equal footing,” and that “[m]eeting halfway will not work, as our market is largely open; we expect an effort in rebalancing this asymmetry.”²⁹

The EU position toughened in the first half of this year, as Brussels responded to China’s more aggres-

25 European Commission, [On Significant Distortions in the Economy of the People’s Republic of China for the Purposes of Trade Defense Investigations](#), December 19, 2017.

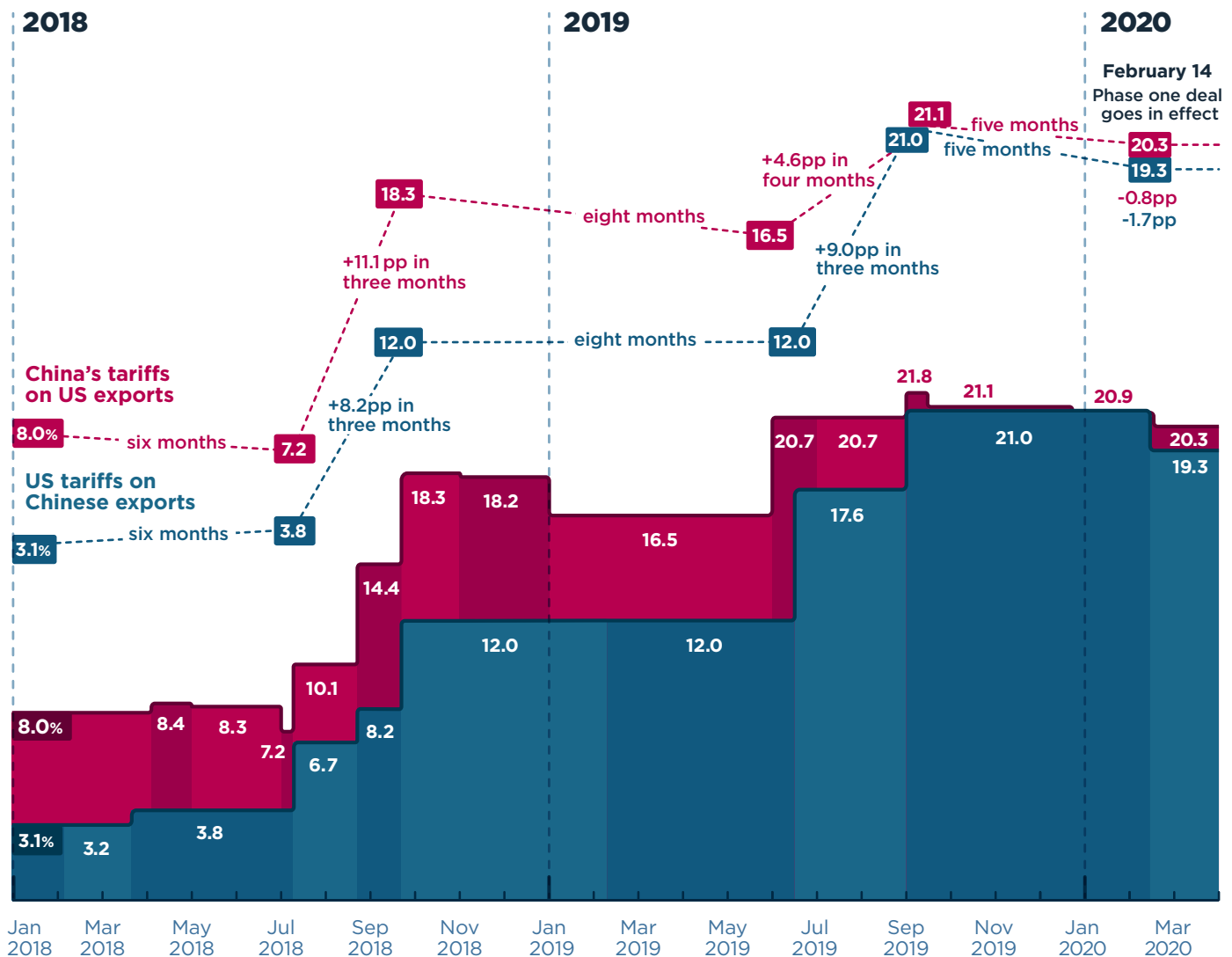
26 Office of the U.S. Trade Representative, [Findings of the Investigation into China’s Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation Under Section 301 of the Trade Act of 1974](#), March 22, 2018.

27 European Commission and European External Action Service, [EU-China: A Strategic Outlook, March 12, 2019](#).

28 BusinessEurope, [The EU and China: Addressing the Systemic Challenge - A Comprehensive EU Strategy to Rebalance the Relationship with China](#), 2020.

29 Phil Hogan, [Speech at the Publication of BusinessEurope’s Strategy Paper on the EU-China Economic Relations](#), European Commission, January 20, 2020.

Figure 3. U.S.-China Trade War Tariffs: An Up-to-Date Chart



Source: Chad P. Bown. 2020. "US-China Trade War Tariffs: An Up-to-Date Chart." Washington, Peterson Institute for International Economics PIIE Chart, February 14.

sive public stance toward (and disinformation about) the coronavirus pandemic and its decision to adopt a national security law for Hong Kong in violation of the Sino-British Joint Declaration of 1984. Plans to use the June EU-China summit to adopt a joint document laying out a strategy for cooperation through 2025 were scrapped at the last minute, despite Xi deciding unexpectedly to attend the virtual meeting. Instead, von der Leyen and European Council Pres-

ident Charles Michel issued a unilateral statement underscoring that China needs to deliver in a number of areas before the EU agrees to more: completing the bilateral investment agreement the two sides have been negotiating for years; reducing industrial subsidies and overcapacity; protecting intellectual property and geographical indications; providing privacy and cybersecurity protection; improving its climate change commitments; collaborating on coronavirus response;

and addressing human-rights issues, including Hong Kong's democratic freedoms and the treatment of minorities in Xinjiang and Tibet.³⁰

The EU and China Economic Policy Issues

In seeking improvement in China's economic policies, the EU is more nuanced than the Trump administration, and much more realistic about its ability on its own to convince Beijing to change. This is in part because the EU regularly runs a current-account surplus (now just over 1 percent of GDP) and has a hefty trade surplus with the United States (second only to China). It is therefore careful to argue—including in the case of China—that bilateral surpluses and deficits do not matter, and that these numbers in general reflect the balance of savings and investment in an economy.

General Economic Policy

Europeans across the political spectrum share U.S. concerns about the distortions in the Chinese economy, the overcapacity those cause, and the export surges that come with it. The EU has an annual High Level Economic and Trade Dialogue with China at which it regularly raises these issues. But the 2017 staff working document is the most detailed explication of the European Commission's views, and it is unsparing. Citing the Chinese constitution, the CCP constitution, the five-year plans, company law, and other legislation, it makes clear that under China's "socialist market economy," the CCP sets economic policy and guides economic decision-making with a range of administrative and financial instruments at literally every level of government (including village), and increasingly in every enterprise, including "private." Its discussion of how the general and sectoral five-year plans (including Made in China 2025 and Supply-Side and Structural Reforms) work at the national, provincial, and city level, and how the plans are binding and enforceable through administra-

tive and other measures is particularly telling. It gives the CCP and government some credit for trying to introduce market forces into the allocation of resources, but argues this effort is weak and has not changed the fundamental non-market character of the economy, where "the Chinese system of planning is geared towards allowing and directing manifold government interventions into the economy."³¹

State Enterprises

The European Union has a more nuanced approach to SOEs as a general matter than the United States. In part because many European countries have long had state-owned firms, the EU by treaty cannot discriminate among firms based on their ownership. That said, publicly owned companies that engage in commercial activity are equally subject to all EU laws, including those on anticompetitive behavior and state aid. This nuance can give rise to differences between the United States and the EU; for instance, this was the case in TTIP negotiations where the United States hoped to get EU agreement on an extensive SOE text very close to that agreed in TPP.³²

Yet there is no difference between the two sides when it comes to their concern about the weight and distortive role of such firms in the Chinese economy. The EU, like the United States, understands that the term SOE in China covers much more than just companies actually owned by the state; it also includes companies—even privately owned—where the government and/or CCP exercise effective control, including indirectly. Even with a narrower definition, the European Commission staff working document cites IMF, WTO, Chinese government data, and numerous other sources to stress that, while "only" 98 firms are directly run from Beijing, there are probably 150,000 SOEs at various levels of government. Together,

30 Ursula von der Leyen and Charles Michel, [EU-China Summit: Defending EU Interests and Values in a Complex and Vital Partnership](#), European Council, June 22, 2020.

31 European Commission, [On Significant Distortions in the Economy of the People's Republic of China for the Purposes of Trade Defense Investigations](#), p. 49.

32 U.S. Trade Representative, [TPP Final Text: State Owned Enterprises and Designated Monopolies](#), (undated)

non-financial SOEs held nearly \$30 trillion in assets in 2013, including nearly 40 percent of all assets in the industrial sector. The EU fully agrees that Chinese attempts to reform SOEs since the Third Plenum have merely reflected a determination to further develop the dominant role of the state-owned economy, in particular by selectively creating large SOEs, shielded from competition domestically and expanding internationally which would serve the Government's strategic industrial policies rather than focusing on their own economic performance [...] In other words, the management of SOEs does not appear to be conducted on an arm's length basis, contrary to normal practice in modern market-based economies.³³

The EU tries to encourage China to change this non-market approach to SOEs in part through the EU-China Competition Policy Dialogue, the terms of reference of which were updated at the 2019 EU-China summit. More significantly, the EU is acutely aware that its merger law does not adequately address Chinese SOEs—even though the consolidation of two SOEs into a megafirm could have significant effects on the EU market, the EU cannot review this as ownership by the state has not changed. Further, when reviewing mergers in Europe (as in last year's Alstom-Siemens rail case), it must focus on the impact on the EU market, rather than looking at global competition (as with the recent merger of two major Chinese rail firms). The European Commission is very likely to tighten these and other provisions to better account for the reality of the impact Chinese SOEs have on the global market.

Subsidies and Overcapacity

The EU fully shares the U.S. view that the nature of China's non-market economy and the privileged place of SOEs (including state-owned/-controlled banks) in it lead to extensive subsidization of the industrial

sector and massive overcapacity.³⁴ In discussing the interplay of state plans and various levels of government, the 2017 staff working document of the European Commission notes:

While overall Chinese policy has also aimed to curtail overcapacity, in fact, Chinese industrial policy has led to the opposite, resulting in very large overcapacities in a number of sectors—often characterised by a high share of SOEs—such as steel, aluminum, ceramics, and wind power... It has not been uncommon that while the central government focuses on curbing a sector riddled by overcapacity, a local government will at the same time seek to maintain or develop that sector into one of its pillar industries [If] specific industries are encouraged, local subsidies and tax relief for companies often lead to over-investment.³⁵

The document devotes an entire chapter to explaining how central, provincial, and local banks channel the funds they are swamped with to favored projects and SOEs, while the private sector depends more on “shadow banking” mechanisms. It goes on to describe three specific industries — solar panels, e-vehicles, and robotics — where these dynamics play out repeatedly. For example, it notes that China's 2016–20 Robotics Industrial Development Plan sets an annual production target of 100,000 industrial robots under Chinese brands; that the State Council explicitly stated that special funds from the central budget and from banks should encourage this; and that by 2017 even the State Council realized China had already developed an overcapacity problem as it had more than 800 robotics enterprises, with some 72,400 industrial robots produced in 2016, up 34.3 percent year on year.

33 European Commission, [On Significant Distortions in the Economy of the People's Republic of China for the Purposes of Trade Defense Investigations](#), pp. 85–108.

34 This is also the main complaint of the Federation of German Industries. See [China — Partner and Strategic Competitor: How Do We Deal with China's State-Controlled Economy?](#), January 10, 2019; and BusinessEurope, “The EU and China”.

35 European Commission, [On Significant Distortions in the Economy of the People's Republic of China for the Purposes of Trade Defense Investigations](#), p. 19

The pervasiveness of subsidies and overcapacity in the Chinese economy has compelled the EU, like the United States, to adopt numerous trade-defense actions against China. As noted, the debate about the country's Market Economy Status ended with the EU withdrawing its WTO reservation on China as a non-market economy, but adopting a new law that allows for essentially the same AD/CVD methodology for countries with systemic distortions—with the first (and so far only) country designated being China. China filed a WTO case against the EU for this sleight of hand, which it lost in June. It did not appeal the decision against it, which allows the EU to effectively continue regarding it as a non-market economy.³⁶

The EU is now considering going much further than the United States and other countries have ever contemplated in combating foreign subsidies.

China is by far the biggest target of EU AD/CVD cases: 93 out of 140 such measures in place at the end of 2019. (Russia was second with 10.) Further, the European Commission toughened enforcement by initiating four cases last year against China for trying to circumvent these AD/CVD orders.³⁷ And, as mentioned above, the EU levied countervailing duties on glass-fiber imports from two Chinese firms based in Egypt specifically because they benefited from subsidies provided from China.³⁸

As with SOEs, the EU also uses capacity building to help China tame the beast its system creates, in particular by explaining to China how the EU applies its own state-aid rules (which are considerably tougher than WTO subsidy rules) to discipline subsidies that distort competition in the domestic market.³⁹ It has also convinced China to discuss further disciplines on industrial subsidies in the WTO in the EU-China Joint Working Group on WTO Reform.⁴⁰

The EU has also agreed, in the context of the U.S.-EU-Japan “level playing field” discussions, to strengthen existing WTO disciplines on industrial subsidies with unconditional prohibitions on unlimited guarantees, subsidies to insolvent firms absent a restructuring plan, and subsidies to enterprises operating in sectors or industries of overcapacity unable to obtain long-term commercial financing. Additionally, the EU will support the United States and Japan in arguing for a reversal of the burden of proof on harm from excessively large subsidies; subsidies that prop up uncompetitive firms and prevent their exit from the market; subsidies creating massive manufacturing capacity, without private commercial participation; and subsidies that lower input prices domestically in comparison to prices of the same goods when destined for export.⁴¹

But the EU is now considering going much further than the United States and other countries have ever contemplated in combating foreign subsidies. This stems in part from the origins of the EU: government intervention in the economy was prevalent in the 1950s when the European Economic Community was established, and the six original signatories to the

36 See Bruce Baschuk, [China Loses Landmark WTO Case Against the EU](#), Bloomberg, June 16, 2020.

37 European Commission, [38th Annual Report on the EU's Anti-Dumping, Anti-Subsidy, and Safeguard Activities and the Use of Trade Defense Instruments by Third Countries Targeting the EU in 2019](#), April 30, 2020.

38 European Commission, [Commission Implementing Regulation \(EU\) 2020/870 of 24 June 2020 imposing a definitive countervailing duty and definitively collecting the provisional countervailing duty imposed on imports of continuous filament glass fibre products originating in Egypt](#), June 25, 2020, pp. 10–63.

39 European Commission, [State Aids: Commission and China Start Dialogue on State Aids Control](#), June 2, 2017; Margaret Vestager and He Lifeng, [Memorandum of Understanding on a Dialogue in the Area of the State Aid Control Regime and the Fair Competition Review System](#), June 2, 2017. A further MOU was concluded at the April 2019 summit.

40 [EU-China Joint Summit Statement](#), April 9, 2019, paragraph 13: “To this end, both sides will intensify the discussions with the aim of strengthening international rules on industrial subsidies, building on the work developed in the Joint EU-China working group on WTO reform.”

41 [Joint Statement of the Trilateral Meeting of the Ministers of Trade of Japan, the United States, and the European Union](#), January 14, 2020.

treaty agreed that only an independent third party could ensure that such state aid would not artificially damage competition between them. EU state-aid rules, adjudicated exclusively by the European Commission, are accordingly the strongest in international law. But these rules apply only to aid granted by member-state governments to their enterprises. In June the Commission issued a white paper arguing that subsidies by non-EU governments could also affect the EU's single market in ways not captured by EU or international law. It proposed that it and/or member-state authorities be permitted to scrutinize and impose penalties and even prohibitions in instances where such subsidies distort competition in the European market. Importantly, the white paper defines a subsidy broadly as a benefit granted to a company directly or indirectly by a foreign government or body acting on behalf of that government.

The European Commission is specifically interested in instances where such subsidies affect foreign acquisitions of EU firms, bids for government procurement, or access to EU funds (including through the EU's substantial research and development programs); firms involved in those activities would have to declare whether they had received any such benefits during the previous three years.⁴² While many (if not most) Chinese firms could be caught by this, there is some concern that other companies (for example, companies that get tax advantages in the United States) could be as well, although any EU action would need to be consistent with its WTO Agreement on Government Procurement (GPA) obligations.⁴³ The European Commission is seeking comments on these ideas and will likely propose legislation related to them in 2021.

Trade Liberalization/Market Access

The EU agrees with the United States about the distortions abetting overcapacity in the Chinese economy

and the unfair exports this generates, and also that China is too closed to imports. The EU's 2018 Trade and Investment Barriers report notes that "for the first time, China has taken over as the country with the highest stock of recorded barriers, with 37 obstacles hindering EU export and investment opportunities." It valued the amount of trade affected by the four new barriers China erected in 2018 at more than €25 billion (mainly related to the sale of telecommunications equipment), far outweighing the impact of barriers by other countries (including the United States).⁴⁴ The European business sector is similarly incensed about China's barriers to trade in services, where EU export penetration is weak. The report notes that even when there are improvements in a sector (for example, legal services), that sector can simultaneously see added restrictions. Further, European businesses are deeply worried that "China is by far the most restrictive major economy on digital trade."⁴⁵

The EU agrees with the United States about the distortions abetting overcapacity in the Chinese economy and the unfair exports this generates.

While the EU complains about China's trade barriers (including in the WTO), it takes little effective action against them, in part as it has few legal mechanisms to do so. Of its nine WTO cases against China, one (auto parts, done with the United States in 2006) is against trade barriers (most of the others concern Chinese AD/CVD practices; one is against China's export restrictions on rare earths). The EU supports China being part of the trade in services negotiations (the United States does not), but refuses to negotiate a

⁴² European Commission, [White Paper on Levelling the Playing Field with Regard to Foreign Subsidies](#), June 17, 2020.

⁴³ Valentina Pop, "EU Moves to Shrink Chinese, U.S. Influence in Its Economy," Wall Street Journal, June 17, 2020.

⁴⁴ European Commission, [Report from the Commission to the Parliament and the Council on Trade and Investment Barriers](#), 1 January 2018–31 December 2018, June 17, 2019. The current count of active barriers is 39, with 4 (mainly telecom), and 1 so far in 2020 (certification of agro-food exporters), implying 3 were resolved during 2019; see European Commission, [Market Access Data Base/China](#), accessed May 15, 2020.

⁴⁵ BusinessEurope, [The EU and China](#), p. 61.

trade agreement until China concludes the investment agreement the two have long been negotiating.

Government Procurement

European businesses have long complained they are essentially barred from competing for China's government procurement market, even through their operations in the country.⁴⁶ This is particularly galling for the EU, which argues it is by far the world's most open procurement market. (Under EU law, member states may not discriminate in favor of their own companies over those from other member states in buying goods and services, so it makes little sense to discriminate against third countries either.) This is one reason the EU has made substantial commitments under the GPA, and it has pressed China (including at the June summit) to make substantial offers in fulfilling its 2001 commitment to join the GPA.

European businesses have long complained they are essentially barred from competing for China's government procurement market.

But the EU does not believe China's membership in the GPA would be enough. In 2012 the European Commission proposed an International Procurement Instrument that would essentially force reciprocity into procurement decisions, citing closed markets in China, India, and (allegedly) the United States. While Germany and the United Kingdom shot this down at the time, a revised commission proposal, submitted in 2016 (mainly as leverage in the TTIP negotiations with the United States), received new wind in 2019 specifically because of concerns about China.⁴⁷ The International Procurement Instrument, which may be adopted this year, would enable the Euro-

pean Commission to identify and negotiate with any country where the EU does not have reciprocal access in government procurement; if these talks fail, the EU could direct member states to levy a 20 percent surcharge on bids by companies from that country. The aforementioned white paper on foreign subsidies goes further, requiring all firms bidding on a procurement opportunity to declare direct or indirect subsidies from a foreign government during the previous three years. The authorities would then determine whether that subsidy gave the firm an unfair advantage; if so, it could be barred from competing for any bids in that member state for a number of years.

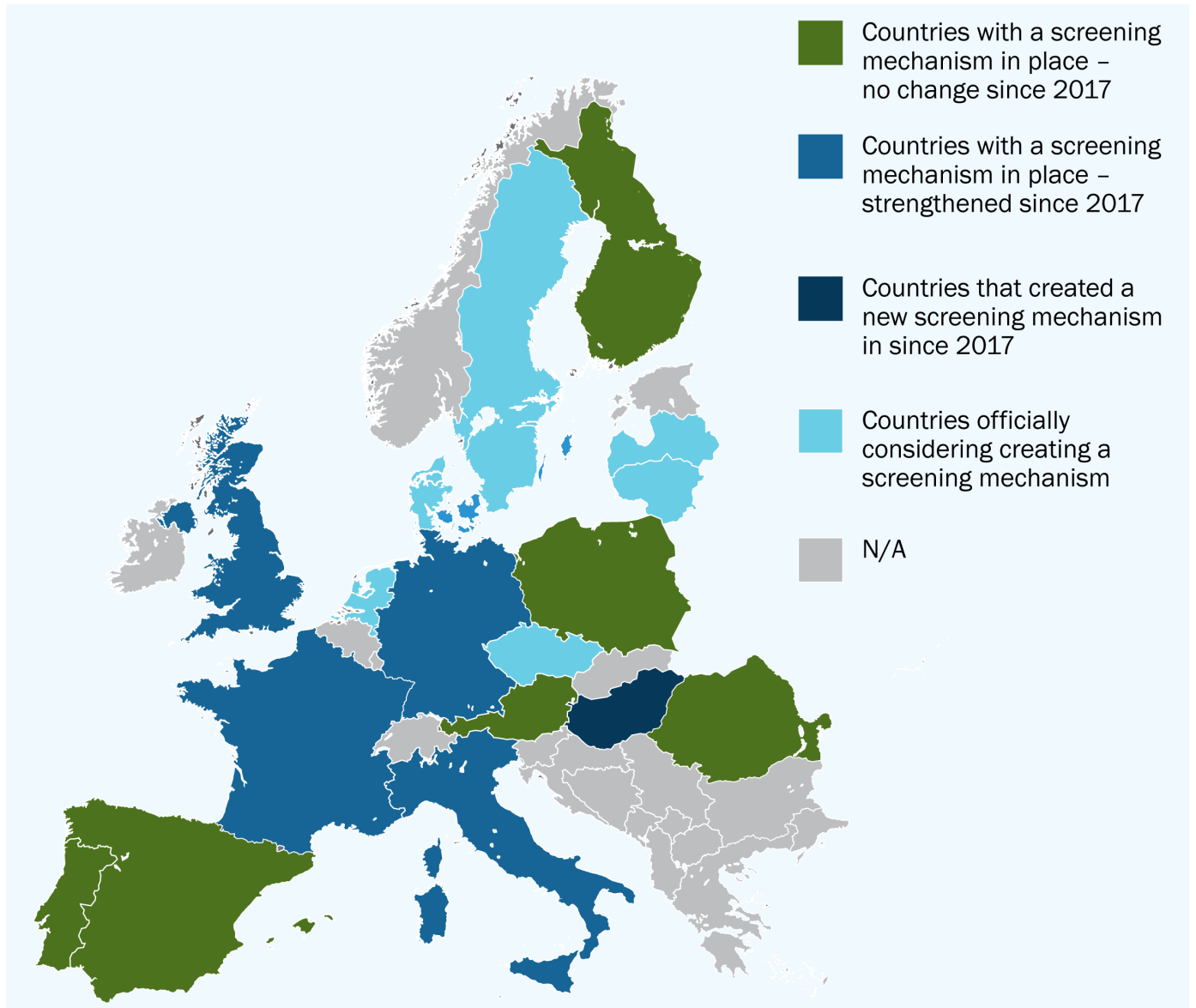
Investment

The EU's most important negotiation with China is toward a Comprehensive Agreement on Investment (CAI). This is also an area where EU frustration about the lack of closer collaboration with the United States is palpable, as the latter refuses to discuss its own Bilateral Investment Treaty negotiations with China with its EU counterparts, even though the two sides have the same objectives. This is particularly surprising as the United States and EU hope to use their investment treaties with China to impose novel disciplines on SOE behavior and privilege, and differences in their degree of ambition and language can be important. The CAI negotiations, launched in 2013, have been tough, but the EU has managed to press China to take a "negative list" approach (identifying areas where it will not commit to national or most-favored-nation treatment) and to progressively reduce the size of that list. Brussels believes Beijing firmly committed in the 2019 EU-China summit to concluding the talks by the end of 2020—although such promises have been made before, and Trade Commissioner Hogan stressed that the quality of the agreement is more important than the timing.

The dynamics of the bilateral investment relationship, however, have changed dramatically since 2015–16, when an onslaught of Chinese investment in Europe reached into sensitive high-tech industries. This was exemplified by the 2016 acquisition

⁴⁶ Ibid, see especially pp. 73–77. See also Federation of German Industries, "China."

⁴⁷ Jana Titievskaia, [EU Legislation in Progress: EU International Procurement Instrument](#), European Parliament Research Service, March 2020.

Figure 4: EU Member States and FDI Screening Mechanisms

Source: Business Europe, *The EU and China: Addressing the Systemic Challenge - A Comprehensive EU Strategy to Rebalance the Relationship with China*, February 26, 2020.

of a leading German industrial robotics company, KUKA, quickly followed by the attempted Chinese acquisition of another such firm, Aixtron. (The latter was ultimately blocked by the Committee on Foreign Investment in the United States for security reasons, as Aixtron had merged with a U.S. company, Genus, in 2005.) The trade ministers of Germany, France,

and Italy wrote a joint letter in February 2017 arguing for EU-level controls against foreign acquisitions to ensure reciprocity, protect EU competitiveness, and ensure security.⁴⁸ This was immediately echoed by a

⁴⁸ German Federal Ministry for Economic Affairs and Energy, [Proposals for Ensuring an Improved Level Playing Field in Trade and Investment](#), February 2017.

legislative proposal by some of the leading advocates of free trade in the European Parliament.⁴⁹ This put the European Commission in a bind as the reciprocity and competitiveness arguments contravened its open-market ethos, while the EU itself has no competence in national security, an area the member states have kept for themselves.

The EU system is not as tough as the controls of the Committee on Foreign Investment in the United States, but it is a significant step.

The European Commission squared this circle in September 2017 by proposing a mechanism to facilitate cooperation among member states on foreign investment that could affect national security or public order.⁵⁰ The law as adopted (in near-record time in March 2019) adheres to the commission's desire to focus on screening for national-security purposes rather than reciprocity or competitiveness concerns. It recognizes that not all member states have or will have screening mechanisms, but permits those that do to keep them, while providing guidance on what they should contain. This importantly includes the ability to look at the ultimate owner, especially when a firm is owned or controlled by a government, and a list of areas related to national security and dual use, such as critical infrastructure, artificial intelligence, robotics, semiconductors, cyber security, energy storage, aerospace, defense, quantum computing, and nuclear, nano- and biotechnologies. Member states (even those without screening mechanisms) are required to notify the European Commission (and, through it, the other member states) about investments in these areas; member states may also independently raise

concerns about investments they believe could affect their/the EU's security. The commission may provide an "opinion" about an investment to the member state concerned (and "shall" send an opinion if one-third of the member states express reservations), but in the end that country needs to make the decision to block or unwind an investment (although it must take the commission's opinion "into utmost account" in the event of an investment potentially affecting an EU program, and justify its decision should it choose not to follow the opinion).⁵¹

The EU system—which will be fully implemented by November—is not as tough as the controls of the Committee on Foreign Investment in the United States, but it is a significant step in four ways.

First, in its focus on national security when the EU has no right to legislate in that area, and in encouraging member states to adopt or strengthen their regimes. Second, in beating back what could have been a much more protectionist approach (which might have easily affected U.S. or Japanese interests). Third, in getting all 27 member states—including the 13 who do not have screening mechanisms,⁵² who welcome foreign investment in their high-tech businesses, and who do not want Berlin, Brussels, or Paris to make decisions for them—to agree to an approach that ensures transparency and consultation, even though this could put them on the spot. And fourth, in using "circumvention" of the national-security controls as the hook to look at the ultimate beneficial owner of a firm, even though by treaty all European companies must be treated equally, regardless of ownership.

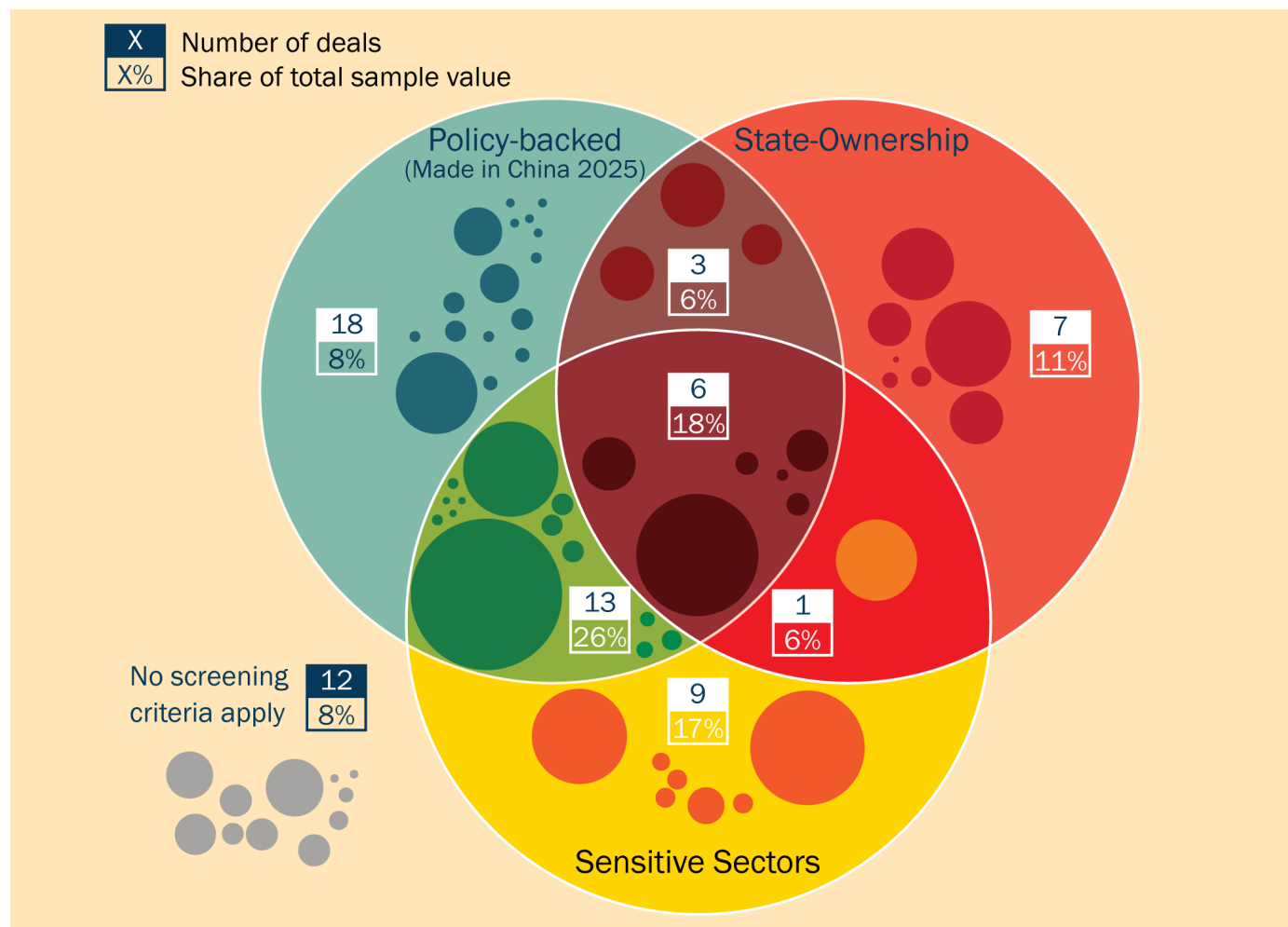
China is never explicitly mentioned as the target, but the piercing of the corporate veil and the greater

49 Manfred Weber et al., [Proposal for a Union Act on the Screening of Foreign Investments in Sensitive Sectors](#), European Parliament, March 20, 2017.

50 European Commission, [Welcoming Foreign Direct Investment While Protecting Essential Interests](#), September 13, 2017.

51 European Union, [Regulation \(EU\) 2019/452 Establishing a Framework for the Screening of Foreign Direct Investments into the Union](#), March 19, 2019.

52 Austria, Denmark, Finland, France, Germany, Hungary, Italy, Latvia, Lithuania, the Netherlands, Poland, Portugal, Romania, and Spain (but not Belgium, Bulgaria, Croatia, Cyprus, Czechia, Estonia, Greece, Ireland, Luxembourg, Malta, Slovakia, Slovenia, or Sweden). European Commission, [List of Screening Mechanisms Notified by the Member States](#), updated April 15, 2020.

Figure 5: EU Screening and Chinese Investment

Source: Agatha Kratz, Mikko Huotari, Thilo Hanemann, and Rebecca Arcesati, *Chinese FDI in Europe: 2019 Update*, Mercator Institute for China Studies, April 8, 2020.

reservations in the law about companies owned or working under the influence of a government make clear China is in the EU's sights. According to a study of a large sample of Chinese acquisitions in Europe in 2018, 83 percent of the transactions would meet the sensitive sector, state-ownership, or policy-motivated criteria for screening:

46 percent of transactions fall in one of the sectors marked as sensitive (accounting for 71 percent of total sample value); 25 percent of the transactions

were done by state-owned entities (representing 41 percent of total sample value); and 58 percent (in both number and value terms) fall into a sector linked to the Made in China 2025 program. More than one-third of transactions in our sample (60 percent of the sample value) meet at least two of these criteria, and one in ten (and 18 percent of the sample value) meet all three.⁵³

⁵³ Hanemann, Huotari, and Kratz, [Chinese FDI in Europe, 2018 Trends and Impact of New Screening Policies](#), pp. 18, Rhodium Group and the Mercator Institute of China Studies, March 2019.

This changes the dynamics in the CAI negotiations: while China has been skittish about committing to protections for European investors, it may now see the agreement as protecting its investors in Europe as well.

Intellectual Property Protection and Emerging Technologies

For years, Europe's main concern about intellectual property was the flood of counterfeit and pirated goods imported from China undermining the profitability of its luxury goods, auto parts and pharmaceutical manufacturers, as well as of its artists.⁵⁴ This remains a concern, which the EU-China Customs Dialogue is trying to address.

Europe's far bigger worry today is China's acquisition of key industrial and other technologies, including through forced technology transfer from European investments in China and cyber-theft (including potentially through 5G). For Europe, this is most immediately an issue of competitiveness: China's growing industrial prowess competes directly with manufacturing-oriented Europe. But as the investment-screening decision above indicates, the EU has also become increasingly sensitive to the national-security implications of transfers of military and dual-use technologies to China, even though it does not have the same "hard" security interests in Asia as does the United States.

Technology transfer is a touchy subject in EU-U.S. relations because European countries sometimes question U.S. motives for using it in trade matters and because EU powers on export controls are limited (as in the case of national security and investment). That said, it is also an area where EU officials believe ongoing cooperation is generally good and in the EU's interest.

54 China regularly accounts for about 90 percent of the EU's counterfeit imports. See European Commission, DG Taxation and Customs Union, [Report on EU Customs Enforcement of Intellectual Property Rights](#), 2018, September 19, 2019.

On the first point, the EU is watching warily as the United States updates its export controls. While export controls have a long history,⁵⁵ a new stage in U.S. policy started with the announcement of a Third Offset Strategy in 2014.⁵⁶ In it the U.S. government recognized that military supremacy required access to an increasing number of technologies designed by firms neither in the traditional defense sector nor necessarily American. This was followed by a major confidential assessment of Chinese acquisitions of key technologies completed in the fall of 2016, briefed to President Trump in early 2017, and published in January 2018.⁵⁷ The report was a major factor behind the 2018 updates of U.S. laws governing technology exports, the Foreign Investment Risk Review Modernization Act (FIRRMA)—with final implementing regulations issued in January 2020—and the Export Control Reform Act (ECRA). The Commerce Department's Bureau of Industrial Security (BIS) is beginning to issue final rules governing exports of and investments in (through a tie to FIRRMA) 14 emerging and foundational technologies, including in the areas of artificial intelligence, quantum computing, advanced computing, 3D printing, positioning and timing technologies, data analytics, brain-computer interfaces, advanced materials, biotechnology, logistics technologies, advanced materials, robotics, surveillance, and hypersonics.⁵⁸

European firms lead in many of these areas and are concerned about how the United States will implement the new controls. A recent case illustrates the

55 Primarily the Coordinating Committee on Multilateral Export Controls, 1950–94, and its successor Wassenaar Arrangement, 1996–present, but also the Nuclear Suppliers Group, the Missile Technology Control Regime, the Australia Group and various international conventions on nuclear nonproliferation, biological weapons and chemical weapons.

56 Bob Work, [Remarks on Third Offset Strategy](#), U.S. Department of Defense, April 28, 2016.

57 Michael Brown and Pavneet Singh, [China's Technology Transfer Strategy: How Chinese Investments in Emerging Technology Enable a Strategic Competitor to Access the Crown Jewels of American Innovation](#), Defense Innovation Unit Experimental, January 2018.

58 The BIS issued its first final rule under ECRA, on the use of [artificial intelligence in the analysis of geospatial imagery](#), on January 6, 2020.

point. The Dutch firm ASML is one of the world's technology leaders in the lithography equipment that produces integrated circuits, for which China is a major market. The United States recently used its export-control laws to effectively prevent ASML from shipping critical parts to China, and some in Europe wondered whether this was not in part because ASML's main competitors are American.⁵⁹

Despite some doubts about U.S. intentions, the EU for its own purposes wants to update its export-control regime.

Despite some doubts about U.S. intentions, the EU for its own purposes wants to update its export-control regime. This effort is increasingly directed toward China. As noted above, the European Union's powers to legislate on national-security issues is limited; member states jealously guard their prerogatives in this area. The EU's current export control system, which dates from 2009, accordingly is a Council Regulation (that is, one adopted by the member states) under which the EU essentially brings UN Security Council, the Wassenaar Arrangement, and other export-control regime decisions into EU law. The European Commission has long argued this is insufficient, not least as it wanted a greater role in the process. Problems with the export of cybersurveillance equipment and human-rights issues in the Middle East provided a hook for the it in 2016 to try again to reform and integrate the system more into EU law, giving itself a mechanism to make certain tech-

nologies subject to EU controls even if not controlled by other international fora, and importantly also including "soft" technology transfers, including through researchers.⁶⁰ The European Commission hopes the heightened concern about the China-technology-security nexus seen in the EU investment-screening debate will help in this regard, including through the naming of the sensitive technology areas listed above, which correspond to many of the technologies being investigated by the BIS in the United States. U.S. as well as Japanese officials have been talking to their EU and member-state counterparts about the need for the three sides to have a coordinated approach independent of Wassenaar decisions, including in terms of how they connect to investment-screening decisions. However, more pressure may be needed to break through member-state reluctance to cede too much authority to Brussels on this.⁶¹

Beyond investment and export controls, the EU and European industry share U.S. concerns about China's technology acquisition through forced technology transfer, not least as they see Chinese firms quickly catching up and even surpassing European manufacturers in many areas. BusinessEurope in February stressed that this is a top priority, noting that

European companies are increasingly subject to practices of forced technology transfer in China. The number of reported cases [in China] of forced technology transfer in order to maintain market access has doubled from 10 percent in 2017 to 20 percent in 2019. Alarming, 63 percent of all cases reported by European businesses highlight that this

59 See Alexandra Alpert, Toby Sterling and Stephen Nellis, [Trump Administration Pressed Dutch Hard to Cancel China Chip-Equipment Sale](#), Reuters, January 6, 2020. While the ASML machines themselves did not reach the 25 percent U.S. content threshold to allow U.S. Export Administration Regulations to apply, the threshold did apply to certain critical components. See also Chad Bown, [Export Controls: America's Other National Security Threat](#), Peterson Institute of International Economics, May 2020, for a discussion of third-country concerns about U.S. use of national security-based policy in the wake of the use of Section 232 on steel, aluminum, autos, [uranium](#), and more recently [laminations and wound cores for transformers](#) and [mobile cranes](#).

60 European Commission, [Proposal for an EU Regulation Setting Up a Union Regime for the Control of Exports, Transferring, Brokering Technical Assistance, and Transit of Dual Use Items](#), September 28, 2016.

61 See Beatrix Immenkamp, [Briefing – EU Legislation in Program: Review of Dual-Use Export Controls](#), European Parliament Research Service, November 2019, on the differences on the legislation between for a discussion of the member states, the European Commission, and the European Parliament. See also Noah Barkin, [Export Controls and the U.S.-China Tech War: Policy Challenges for Europe](#), Mercator Institute for China Studies, March 18, 2020, on what the EU should do to avoid a falling out with the United States on this issue.

happened within the last two years, with 25 percent of those cases currently taking place. These developments occur despite official government pledges to prohibit this type of activity.⁶²

The European Union filed a WTO complaint against China on technology transfer in June 2018, based largely on the research feeding the 2017 Staff Working Document on the country's systemic distortions.⁶³ The complaint, which has been joined by the United States and Japan, argues that China imposes mandatory contract terms governing the import and licensing of technologies as preconditions for investment that are less favorable than those domestic firms face. The complaint and its elaboration in December 2018 point to nearly two dozen laws and practices that are used to compel foreign firms to transfer technology to China, in a sense codifying and even expanding on the U.S. Trade Representative's Section 301 report on China's technology theft. The EU case is still being heard, although the weakening of the WTO dispute-settlement process by the United States could undermine the chances of a decision in the EU's favor.

5G

Fifth-generation wireless communication (5G) is a special high-technology issue. 5G relies on ultra-high frequencies (24–86 gigahertz) to provide the extremely high speed and low latency (buffering) transmission of data that will be needed to realize the benefits of the Internet of Things, such as connected/autonomous driving.⁶⁴

In part because of forced technology transfer and government supports, the Chinese telecommunica-

tions firm Huawei is the global leader in developing and supplying this technology.⁶⁵ Finland's Nokia, Sweden's Ericsson and South Korea's Samsung are its only serious competitors. The U.S. government has serious concerns about the integrity of Huawei's systems, not least as under Chinese law Huawei and any other Chinese firm must give the government any information it demands, and China has a significant history of undertaking cyberattacks. Washington has accordingly pressured European governments not to buy 5G equipment from Huawei (including by threatening to cut off access to U.S. intelligence), even though the company has supplied substantial amounts of Europe's current telecommunications infrastructure.⁶⁶ While the United Kingdom, Germany, and other countries are still debating how to handle the issue, the European Commission won plaudits from the United States for signaling as early as March 2019 its own concerns about the integrity of Huawei's systems and publishing in January a toolbox for member states to assess their 5G procurements, which focuses particularly on the need for "trusted vendors."⁶⁷

WTO

The European Union would like to work more with the United States in the WTO to address the challenges China's economic system poses to the global economy, but this is hindered by EU concerns about the Trump administration's approach to the organization.

As a structure created by treaty, the EU is deeply wedded to international law and institutions. The WTO is particularly important to the European Commission as it is one of the few major multilat-

62 BusinessEurope, [The EU and China](#), p. 82.

63 World Trade Organization, DS549: [China: Certain Measures on the Transfer of Technology](#), accessed May 10, 2020. See also European Commission, [On Significant Distortions in the Economy of the People's Republic of China for the Purposes of Trade Defense Investigations](#), pp. 169–201.

64 See, for example, CB Insights, [What is 5G? Understanding the Next-Gen Wireless System Set to Enable Our Connected Future](#), March 19, 2020.

65 Chuin-Wei Yap, [State Support Helped Fuel Huawei's Global Rise: China's Tech Champion Got as Much as \\$75 Billion in Tax Breaks, Financing, and Cheap Resources as It Became the World's Top Telecom Vendor](#), Wall Street Journal, December 25, 2019.

66 See, for example, Joakim Reiter, [5G After COVID-19](#), Lawfare, April 16, 2020.

67 European Commission, [Secure 5G Networks: Commission Endorses EU Toolbox and Sets Out Next Steps](#), January 29, 2020. See also the links in this press release.

eral institutions where the EU itself has a seat.⁶⁸ And while the United States and the EU regularly spar in WTO negotiations, EU and member-state officials firmly believe that the organization exists because the United States and EU joined forces to build it out of the predecessor General Agreement on Tariffs and Trade (GATT) in 1995.

The perception in Brussels and most European capitals is that the Trump administration does not really want to improve the WTO but rather to sideline or eviscerate it.

It is therefore all the more galling for EU officials to see the United States undermining what they consider the WTO's crown jewel: its dispute-settlement system, which improved upon the GATT by facilitating enforcement of WTO rules through binding dispute settlement and the introduction of an appeals process. The EU agrees with many of the specific U.S. concerns about the functioning of the organization and the Appellate Body. In 2018, the European Commission published a concept paper on WTO modernization that would address many U.S. complaints.⁶⁹ It advocated "graduating" countries like China away from "special and differential treatment;" strengthening WTO rules on state-owned enterprises, subsidies, and technology transfer; and improving dispute-settlement procedures. The perception in Brussels and most European capitals, however, is that the Trump administration does not really want to improve the WTO but rather to sideline or eviscerate it. No EU official is particularly proud that in March the EU "succeeded" in bringing 15 other countries (including China) on board to create a "contingency appeal arrangement

for trade disputes" since the United States essentially shut down the Appellate Body.⁷⁰ And the irony of the United States claiming a victory in its WTO case against EU subsidies of Airbus while so hobbling the WTO that it could not issue a final ruling on the EU's complaint against U.S. subsidies of Boeing is not lost upon European officials.

Despite these tensions, the EU has worked closely with the United States and Japan to develop potential new international disciplines on industrial subsidies, SOEs, and technology transfer that ideally could be adopted in the WTO.⁷¹ It is pressing China to accept these disciplines in high-level meetings, including the June EU-China summit and the EU-China Joint WTO Reform Working Group, and it hopes to see some of them embodied in the EU-China CAI.

There is also some receptivity among EU and member-state trade officials to a stronger approach by building a large international coalition of developed and developing countries to bring a comprehensive case in the WTO against China. The idea would be to put together a comprehensive case on a broad range of China's violations of WTO law (on intellectual property rights protections, subsidies, investment restrictions, export restraints, standards, services, agriculture, and transparency) as well as a "nullification and impairment" complaint against its non-market practices.⁷² Although such a case and coalition could be difficult to muster, if properly done it could strengthen the WTO. The EU, United States, and others have collected extensive evidence of problematic Chinese behavior in these areas over the years, and a coalition of countries could avoid retaliation from Beijing. Perhaps most important, such

68 The European Commission exercises the "votes" of its member states in the WTO but does not have its own vote.

69 European Commission, DG Trade, [Concept Paper on WTO Modernization: Proposals on Rule Making, Transparency, and Dispute Settlement](#), September 18, 2018.

70 European Commission, [EU and 15 World Trade Organization Members Establish Contingency Appeal Arrangement for Trade Disputes](#), March 27, 2020.

71 [Joint Statement of the Trilateral Meeting of the Ministers of Trade of Japan, the United States and the European Union](#), January 14, 2020.

72 Jennifer A. Hillman, [The Best Way to Address China's Unfair Policies and Practices Is Through a Big, Bold, Multilateral Case at the WTO](#), testimony before the U.S.-China Economic and Security Review Commission, June 8, 2018.

a case would send a message to China's government and public that the distortions in their economy cause significant external harms that the rest of the world will no longer accept.

The Belt and Road Initiative

In 2013, Xi Jinping first proposed building a Silk Road Economic Belt⁷³ from China through Central Asia to the Baltic Sea as well creating an Asian Infrastructure Investment Bank (AIIB).⁷⁴ The United States immediately opposed both initiatives, arguing that the AIIB in particular duplicated the work of the World Bank and the Asian Development Bank, but it was perhaps more concerned about China gaining new inroads for influence. Europe was much less concerned, and many European countries (with the United Kingdom leading) joined the AIIB, in part to ensure from the inside that it would adhere to typical international procurement and lending practices, which it has. Eighteen EU member states hold 20 percent of its capital.⁷⁵

That said, what is now referred to as the Belt and Road Initiative (BRI) is in many ways the external manifestation of China's internal economic distortions—a way to offload excess currency and capacity in heavy equipment to the developing countries between it and Europe. But the BRI also has a significant strategic dimension as it is meant to strengthen China's alliances with countries in South and Central Asia. This dimension has crept directly into the EU, most notably through the Chinese acquisition of the port of Piraeus in Greece and projects in the Balkans and in Central and Eastern Europe. China has been quick to make use of these connections, including by establishing its own gathering with certain EU member

states (the 17+1 format) and urging Greece, Hungary, and others to block unanimous EU votes against it on, for example, human rights and the South China Sea.⁷⁶

Large infrastructure projects supported by easy BRI money have led to numerous allegations of corruption. Like many infrastructure-oriented geostrategic initiatives, the BRI has had other consequences, not least the debt loads recipient countries face in the post-coronavirus global economic crisis. China is now having to deal with a developing-country debt crisis on par with that of the late 1970s and early 1980s, but this time directly related to it and its banks.⁷⁷

The European Union and its member states are increasingly aware of and worried about Chinese influence, including within their own borders. One response to the BRI has been the EU's Connectivity Strategy,⁷⁸ a reverse BRI (from Europe to Asia) in collaboration with Japan and at least in parallel to the United States' Indo-Pacific strategy. The Connectivity Strategy is meant in part to use EU and Japanese development funds to wean countries away from Chinese offers, but it has thus far consisted more of words than action.

Currency Manipulation

Virtually every U.S. administration since Ronald Reagan's has complained about China undervaluing the renminbi to gain competitive advantage. The Trump administration was the first, however, to formally designate it a currency manipulator in August 2019.⁷⁹ The designation was lifted on January 13, 2020, just before the Phase One deal was signed,

73 Press Release, [President Xi Jinping Delivers Important Speech and Proposes to Build a Silk Road Economic Belt with Central Asian Countries](#), Ministry of Foreign Affairs of the Peoples Republic of China, September 7, 2013.

74 Xinhua, [China Proposes an Asian Infrastructure Investment Bank](#), China Daily, October 3, 2012.

75 Madi Sarsenbayev and Nicolas Veron, [European versus American Perspectives on the Belt and Road Initiative](#), China and the World Economy, 28:2 (2020).

76 François Godement and Abigaël Vasselier, [China at the Gates: A New Power Audit of EU-China Relations](#), European Council on Foreign Relations, December 1, 2017.

77 Agatha Kratz, Daniel Rosen and Matthew Mingey, [Booster or Break? COVID and the Belt and Road Initiative](#), Rhodium Group, April 15, 2020.

78 European Commission and European External Action Service, [Connecting Europe and Asia: Building Blocks for an EU Strategy](#), September 19, 2019.

79 U.S. Department of the Treasury, [Treasury Designates China as a Currency Manipulator](#), August 5, 2019.

presumably because China agreed in that deal to abide by its IMF and G20 commitments to avoid competitive devaluations.

The EU is at best uncomfortable with the U.S. position on this issue. It knows the problems competitive devaluations can cause; that was the primary motivation for creating the euro. On the other hand, this and earlier U.S. administrations have long come close to arguing that the EU verges on currency manipulation, at least insofar as the euro effectively locks in an “artificially low” value for the erstwhile German deutsche mark. Officials in the European Commission and the European Central Bank are also aware that many of China’s recent interventions in currency markets were to prop up the value of renminbi rather than weakening it. Finally, the Trump administration’s growing use of the dollar through “secondary sanctions” (mainly against Iran) has deeply disturbed European countries and is one reason some argue the EU needs more strategic autonomy, including from the dollar-based international financial system. Expanding the use of the euro is part of that, but further internationalization of the renminbi is another.

Building a Transatlantic Alliance Toward a Global Coalition

With so much convergence between them about the challenges China’s economic and trade policies cause, the United States and Europe should be able to work together. EU officials regularly assert their desire to do so and point to specific examples of such cooperation, including in the trilateral effort with Japan toward a level playing field. Yet there is a sense in Brussels and European capitals that the two sides are not cooperating at the level that they could and should. Basically, they lament, the Trump administration does not take Europe, or its possible contribution, seriously.

To an extent, this reflects a difference in the use of carrots and sticks. The EU, which was created to end war and the use of power in international relations in Europe, is built upon the rule of law in the form of the EU treaties. As such, for it law is sacrosanct: countries should abide by the law and things can unravel quickly

if they do not (as the recent difficulties with Hungary and Poland as well as the German’ Constitutional Court ruling on the European Central Bank demonstrate). But the EU has few instruments to enforce that the law; for it, “sticks” come mostly in the form of denial of benefits under the law.

The Trump administration, in contrast, freely wields sticks by effectively denying access to the U.S. market, even when so doing contravenes international law. From the EU perspective, this starts with the administration’s unjustified use of national security under Section 232 of the Trade Expansion Act of 1962 to impose punitive tariffs on imports of steel and aluminum from Europe and the rest of the world. With respect to China, the United States now effectively denies Most Favored Nation treatment in contravention to the U.S. law granting China the status of Permanent Normal Trading Relationship, never mind WTO rules.

European and EU leaders know sticks are needed, but they can only wield them in the context of international law. Thus, the EU denies China Market Economy Status by rewriting its laws to allow non-MES approaches to countries like China (but not just China) that have systemic economic distortions, and files a case in the WTO against China’s forced technology transfers. It argues its decision to launch safeguard measures on imports of steel and aluminum following U.S. use of Section 232 on these products is in the same vein, allowed under WTO rules. (Ironically, some U.S. officials see this as a first hard EU response to China, when it was in fact a response to the trade diversion U.S. policy could cause.)

Despite this tactical difference, the United States needs Europe and the EU if it is to get to the root of the problem of the Chinese export juggernaut. China’s economic policies reflect domestic political choices—maintaining political stability by building the country’s standing in the world, delivering the growth necessary to improve the lives of its people, and ensuring the CCP’s continued rule. As for the United States and every European country, China’s domestic political considerations outweigh the external harms of its poli-

cies, especially if this is limited to a few countries. The CCP can only be nudged to change its domestic policies if a substantial part of the outside world expresses concern; the bigger that coalition of outside forces, the more force it will have domestically in China in raising questions about the legitimacy of those policy choices.

When the United States alone pushes on China, this does little more than elicit a nationalist response, even among those who might be critical of the CCP. In that sense, it legitimizes the policies it wants to change. (Never mind the Phase One agreement that promotes a form of managed trade that fosters Chinese state control.) At the same time, the Trump administration has undermined U.S. ability to assemble a diplomatic coalition to nudge China, in part because of the way it has flouted international rules and flaunted American power.

The EU can build a broader coalition willing to confront China—not against its aspirations for growth and the betterment of its people, but rather because of the external effects of the policies it has adopted. A broad coalition that includes countries like South Korea, Mexico, Malaysia, India, Argentina and others could send messages that would be heard in Beijing, precisely because they would be heard throughout China. This kind of external pressure might bring real change to China's economic policies.

The United States will need to take a number of steps to convince Europe and the EU to be an effective partner in this endeavor. This will also require that the United States reinvigorate its diplomatic skills, including in working with Brussels as well as member-state capitals.

The first step is to rebuild trust in Europe that the United States wants to strengthen the rule of law rather than undermine it. Unfortunately, a majority of European politicians and policymakers do not today believe that, not least as they see Washington applying the rule of power toward them. For Europeans and the EU, this is essential.

The second step is to repair the U.S.-EU economic relationship. This requires efforts from both sides. Europeans point to the United States' use (on steel

and aluminum) or threat (on autos and auto parts) of Section 232, which they see as a violation of WTO law. They are also smarting about the imposition of punitive tariffs on \$7.5 billion of EU products in response to subsidies to Airbus. While they understand these tariffs are consistent with the outcome of the WTO dispute, they believe Washington could have pursued a negotiated solution. But the United States also has legitimate complaints about the EU, including on Airbus and on member-state attempts to levy digital services taxes against U.S. tech firms and their threats of higher duties because of climate change (as with carbon border adjustment mechanisms).

When the United States alone pushes on China, this does little more than elicit a nationalist response, even among those who might be critical of the CCP.

In July 2018 President Trump and European Commission President Jean-Claude Juncker ostensibly laid the foundation for a possible trade deal—in lieu of Section 232 tariffs on autos, a free trade agreement that would be less than TTIP but still provide U.S. and European firms improved market access. Unfortunately, the two sides immediately diverged on whether market access would be only for industrial products. The United States insists on including agriculture, where the EU's market is relatively closed because of high tariffs and food-safety rules Washington finds spurious. The EU rejects including this sensitive sector because President Trump is not willing to put his sensitive issue (government procurement) on the table.

This impasse can and should be broken; it obstructs collaboration on the bigger issue of China's distortions. The EU should agree to include agricultural market access, while the United States should accept that truly sensitive food-safety issues (biotech, anti-microbial treatments for poultry meat) are not part of the trade talks, but will be handled separately by food-safety

regulators, who will look as well at EU complaints about questionable U.S. food safety rules (on Grade A rating for dairy products, for instance). The United States should back down on the Section 232 measures (which have not proved effective anyway) while the EU will have to accept the WTO ruling on Airbus. On that the latter, the EU should agree to end launch aids and have Airbus repay the loans on commercial terms, whether or not the aircraft developed with the aid is profitable, and the United States should accept that the repayment terms can be generous. On the digital tax and climate change, the two sides should agree to continue working on these in the multilateral OECD context.⁸⁰

Each of these three steps requires that the United States rediscover the art—and the work—of diplomacy.

Third, the United States and Europe will only be able to rebuild trust and resolve thorny trade disputes if they rediscover the strategic purpose of their alliance. The United States built up the international rule of law and the institutions to safeguard it following World War II as a bulwark against another global conflagration. Its leaders accepted constraints on U.S. power to save American lives. In the same spirit and with the same purpose, the United States pushed a devastated Europe to recover through integration. That strategy succeeded. But the vision behind it has faded, including in Europe where the purpose of integration is being lost as much through Brussels' overreach as populist cries to resurrect national sovereignty.

In 2007, during the German presidency of the Council of the EU, President Bush and Chancellor Merkel created the Transatlantic Economic Council to re-inject a strategic approach to U.S.-EU economic relations. The original vision for it was to bring

together a range of U.S. cabinet secretaries and EU commissioners for private, informal, crosscutting, and off-the-record conversations about strategic issues. China was the focus of the first TEC meeting, the only one that was true to this original vision. The TEC unfortunately then became mired in trade disputes and went dormant during the TTIP negotiations. It is time to revive it, but in its original form rather than as a bureaucratic exercise.⁸¹

Each of these three steps requires that the United States rediscover the art—and the work—of diplomacy. It tends to think of the EU with exasperation: it is not NATO, where the United States sits at the head of the table; it lacks “hard” power; and it is messy with its three presidents (of the European Commission, Council, and Parliament), 27 heads of state and government, and 26 semi-independent commissioners. For U.S. policymakers, it is so much easier to go to Berlin, Paris, or other capitals and talk to their national counterparts.

But, however messy, weak, and tedious the EU is, it has the ability to gather and focus the capabilities of its member states, and to stymie policies policymakers in, say, Berlin and Paris may support but others do not. The Bush administration learned this during its first term: negatively when efforts to divide “New” and “Old” Europe failed, and positively when the EU proved a key ally in support Ukraine's Orange Revolution. The method of working the EU was demonstrated in 2004 when Washington cooperated simultaneously with member-state capitals and Brussels to convince the EU not to lift the ban on arms exports to China that had been imposed after the violent repression of dissent in Tiananmen Square in 1989. A similar “capitals and Brussels” approach, using all U.S. embassies simultaneously, will be needed to help bring the EU to “yes” on the sensitive issue of including agricultural market access into trade talks and break through the main obstacle to building a global diplomatic campaign to mitigate China's economic distortions.

80 For more detail, see Peter Chase, [Mr. Hogan Goes to Washington: Using Imagination to Break the Transatlantic Trade Impasse](#), German Marshall Fund of the United States, January 15, 2020, and [Time to Hit “Reset” on Transatlantic Trade](#), The Ripon Forum, April 2019.

81 Peter Chase, [Rebuilding Strategy into the Transatlantic Economic Relationship](#), German Marshall Fund of the United States, February 20, 2017.

Conclusion

The United States can try to go it alone in its trade war—or a new Cold War—with China, but it is unlikely to succeed if it does. The Chinese are a proud people, conscious of their history of foreign oppression. As much as many in China question the autocratic rule of the CCP, they will accept it rather than see their country become a weak vassal again. The United States alone cannot raise costs on China sufficiently to change that calculus.

China's leadership knows the fragility of its economy and that this undermines the country's ability to become a world leader. And it knows many of the reforms it needs to undertake. It does not know, however, how to manage the economic and possible political fallout reforms could create.

External influence, applied reasonably and responsibly, could provide Beijing the political cover that domestic change demands. The Chinese public may reject “bullying” by the United States, and probably even “ganging up” by Washington, Brussels and Tokyo. But they would need to think hard if a much larger coalition of emerging and developing countries that accepts China's aspirations for itself complained that its economic distortions, resulting overcapacity, and consequent need to export harmed them. In other words: if the world staged a massive “intervention” against China's addiction to growth.

That is, in effect, what the broad and comprehensive WTO case against China discussed above would

be. A formal complaint by a range of countries against China's violation of WTO rules and its “nullification and impairment” of its promises under its Accession Protocol would have a significant impact, not only on the leaders in Beijing but also on the Chinese people. And it could have sufficient weight to instigate the difficult reforms needed to mitigate those external impacts; to enter into agreements that discipline state aids and discriminatory treatment of foreign imports, investment, and intellectual property; and to put China's economy onto a more sustainable path.

The United States today cannot alone build this coalition; this requires partnership with Europe (as well as Japan and others.) That partnership can come only if both sides share a strategic vision. For Europe, that vision must begin with working to strengthen the international rule of law. Europe will not accept a vision based on putting China down, but it will accept one based on helping China lift itself up, for a prosperous and stable China that is a responsible global citizen is very much in the European interest. That said, Europe is no longer naïve about China, and understands that judicious controls on sensitive technologies will be needed as long as the country has its own power ambitions outside the rule of law.

Europe and the EU are ready to work with Washington, if the United States can work with a constructive vision of China inside the rule of law. With that, and a bit of creativity, respect and diplomacy, that missing partnership can be rebuilt.

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