European Union Institute for Security Studies

Brussels – Beijing: changing the game?

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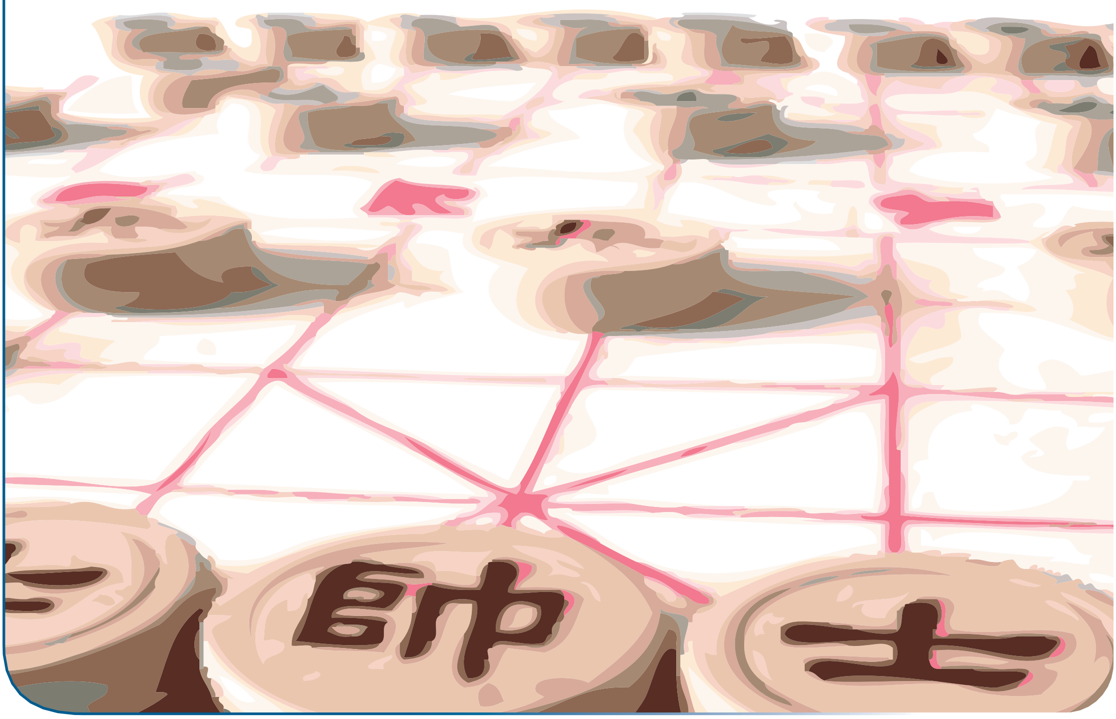

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FOREWORD

We are pleased to present the final report prepared in the framework of the research project 'Developing a comprehensive EU strategy towards China', including the revised papers and commentaries that were presented at the expert meeting organised by the EU Institute for Security Studies in Paris on 11-12 October 2012. The aim of this project was to examine and assess EU policy towards China in the following fields: trade, investment, the euro and global economic governance, environment and resources, defence and security, politics, and the regional context. The contributors evaluate whether the EU has been able to devise a coherent approach towards Beijing, identifying the next steps that could be adopted so as to better promote the Union's interests and values and avoid internal divisions over China.

The report concludes – perhaps unsurprisingly – that China represents a great opportunity but also a challenge for the EU. China is poised to become the EU's most important commercial partner, while simultaneously being a serious challenger in trade and a competitor for resources. In the last few years, a defensive discourse has emerged in some EU member states based on the perception that China has been flooding European markets with cheap products and taking away jobs in the manufacturing sector (a view strengthened by Beijing's active industrial policy). As highlighted by the European Commission in its last *European Competitiveness Report*, China has established itself as a low-cost competitor in high-skill industries. The rapid growth of skill-intensive imports from China represents a serious challenge for European industrial sectors that are considered sensitive. At the same time, the sheer size of the Chinese market and the growing purchasing power of its expanding middle class represent a formidable opportunity for many export-oriented European companies.

Also at the political level there exists a dichotomy of perceptions. China continues to be viewed with suspicion across Europe due to the non-democratic nature of the Chinese regime, raising questions as to what use the new leaders will make of their country's increased capabilities. Yet, it is precisely this authoritarian Communist China, informed by values and principles quite different from those of the EU and its member states, that has come to support the EU's integration process – including key initiatives such as the European common currency. Since 2011, Beijing has disinvested away from dollar-denominated assets, increasing its holdings in euro which now account for around 30 percent of China's foreign reserves. Support for the eurozone has been accompanied by growing Chinese Foreign Direct Investment (FDI) in Europe's industrial sectors and infrastructure projects.

There seems thus to be a dual and sometimes overlapping image of China across Europe: that of a rising power challenging the Old Continent's values and standards of living; and that of an enormous opportunity for European companies and EU global aspirations. Given this situation, devising the right approach towards Beijing is possibly one of the greatest tasks currently facing the EU. In this vein, the contributions in this report offer a number of suggestions that could assist EU policymakers in developing a more coherent and strategic approach towards China.

Acknowledgements

First and foremost, the editor would like to thank the scholars and policymakers who contributed to this project.

The authors of the papers – Axel Berkofsky, François Godement, Jonathan Holslag, Bernice Lee, Miguel Otero-Iglesias, Jonas Parello-Plasner and Frans-Paul van der Putten – did an excellent job in summarising complex issues and delivering their contributions to deadline. They are possibly among the best European experts in their respective fields of specialisation. Their analyses provided much food for thought and generated a lively debate with policymakers during the expert meeting convened in Paris in October 2012.

Special thanks go to the EU officials – Rebecca Fabrizi, Magnus Gislev, Mattias Lentz, Raul de Luzenberger, Felipe Palacios Sureda, Antonio Parenti and Michael Reiterer – who agreed to discuss the papers and provide written comments for inclusion in this report. They took time out from their busy schedules to engage in a fruitful dialogue with the experts. Their contributions offer an authoritative view of the topics at hand, and invaluable insight into current debates within EU institutions.

By bringing together academic experts and policy practitioners, this project intends to contribute to the strategic debate in Europe, including discussion as to what would be the best approach to adopt towards China, a distant but increasingly important actor for the EU.

I would also like to thank the staff at the EUISS who contributed to bringing this project to fruition. Sylvie Deveze provided invaluable support with the organisation of the expert meeting and in managing the administrative aspects of the project. In the publications unit, Gearóid Cronin and Noëlle Tomas (and Catherine Glière in the early stages) did excellent work in looking after the editing and formatting. Last but not least, the EUISS director, Antonio Missiroli, supported the timely publication of this report.

Needless to say, any mistakes are solely the responsibility of the editor and individual authors.

Nicola Casarini

Paris, 28 February 2013

I. TRADE

ASSESSING SINO-EUROPEAN TRADE RELATIONS

Jonathan Holslag

Introduction

Against the current backdrop of global uncertainty, the European Union should let its economic policies be directed neither by protectionism, nor by blind faith in free trade. Instead, it should focus on economic realism. This is particularly urgent in its relations with China. Economic realism seeks to optimise and sustain gains at the lowest possible cost. It does so through an open market if possible and by measured political intervention whenever needed. This chapter makes a case for economic realism in the Sino-European relationship. It starts with a brief account of the main objectives of economic diplomacy. It then evaluates the evolution of Sino-European trade relations between 2007 and 2012, and concludes with a discussion of the EU's policy options.

The four priorities of economic diplomacy

Derived from the notion of economic realism, economic diplomacy is the endeavour to maximise incomes from trade in goods, trade in services, and income transfers from expatriates and investors. It also seeks to attract those foreign investments that contribute to a more competitive economy. To be effective, economic diplomacy starts from a sound domestic economic policy that empowers companies and develops those assets that present a comparative advantage in the global market. Economic diplomacy can be described as the art of combining the pursuit of economic opportunities with measures to fend off external challenges to the national economic interest.

Free trade, by any standard, remains the most effective way to advance prosperity in a way that is durable, balanced and equitable. An open economic order tilts towards more efficiency, greater productivity, and flattens out imbalances before their destabilising effect becomes overwhelming. Open economic orders, however, are not to be taken for granted, and if they occur they are the construction of economic leaders that extract asymmetric gains from a great number of countries which, in their turn, will seize each opportunity to redress this unfavourable position. As a result, open economic orders come under strain whenever their leaders falter. Furthermore, even within an open economic order, the objective of a state is to divert the flows of globalisation to the greatest possible benefit of its citizens.

From that perspective, the main task of polities is to maximise their external income and to make those flows of revenues as durable as possible. Capital inflows – i.e. investment – should be used in pursuit of a more competitive economy. This is not a matter of big surpluses, as promoted by mercantilists in the past. In practice, the most optimal outlook on the balance of payments is a mild current account surplus – smaller than 1 percent of GDP – that is channeled back out of the economy via the financial account in the form of foreign direct investment in profitable or strategic assets like natural resources or infrastructure. Excessive surpluses are to be avoided as they act as a drag on the development of the domestic market. Equally to be avoided are persistent deficits. As Europe is sliding from a mild surplus into growing external debt, it is imperative for Europe to remedy this situation.

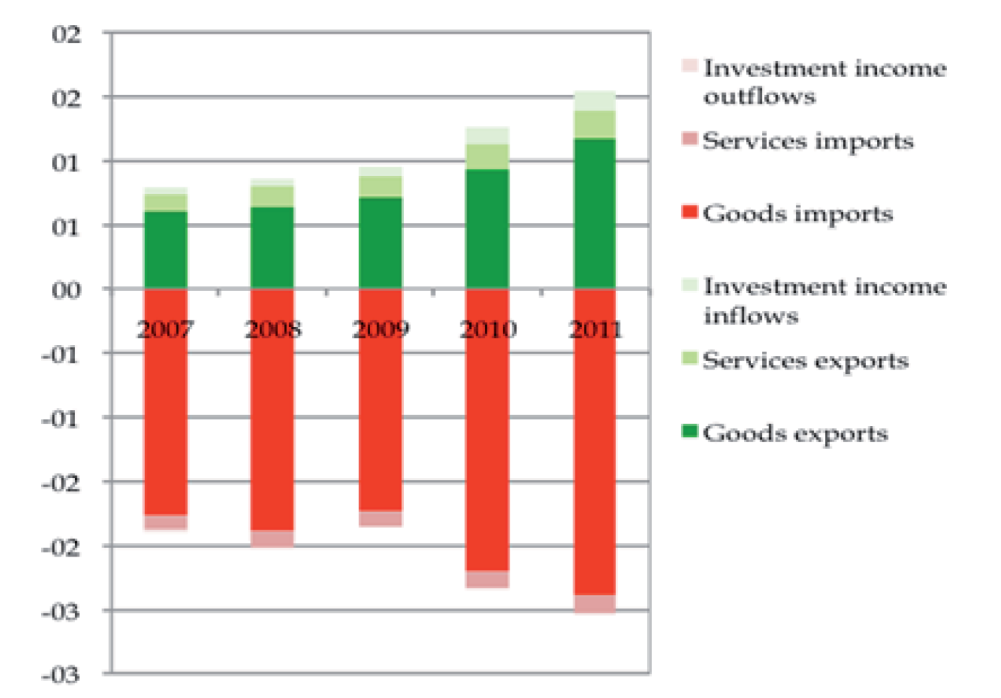
Besides the sheer volume of trade, economic realism takes an interest in its composition and seeks to optimise the share of high-end services and goods in a country's exports portfolio. Not all so-called comparative advantages are equal. Only when a country produces those assets that are most in demand, does its economy reap the largest gains, thereby providing high living standards for its citizens with a minimum of effort.

Last, trade policy has to prevent excessive dependencies. When a market relies on a limited number of scarce resources, a small number of suppliers, or a few exporting powerhouses, the government often weighs in to support this nexus, mobilises extra budgets, and puts in place preferential trading arrangements. This way, however, the development of alternatives to these excessive dependencies is pre-empted, innovation is hindered and, in the end, vulnerabilities aggravated.

China – a trade manipulator?

There have been stumbling blocks and obstacles in the EU and China's trade relationship, and there may well be even more daumting challenges ahead. Since 2007, the trade deficit with China has not decreased, but as a share of the European Union's GDP it only amounts to 1.1 percent whereas, for example, the deficit in energy trade amounts to 11 percent of our GDP. There have been tensions, but these have not led to fierce trade conflicts. On a more positive note, the share of the deficit in our overall trade with China has decreased from 43 to 29 percent. More precisely, our exports to China have increased by 80 percent, whereas Chinese exports to Europe have expanded only by 29 percent. The share of China in our total extra-regional exports grew slightly to 7.5 percent. In addition, profits transferred back from China by European investors more than tripled, reaching €16 billion in 2011. Chinese direct investment in Europe started to increase as well. In third countries, China enlarged its market share in manufactured goods and maintained its position in services. The European Union, however, stayed slightly ahead in manufactured goods and continued to lead strongly in services. China's global trading power has thus expanded globally, probably limiting European progress. However, Beijing was by no means the winner that took it all.

Chart 1: The EU's current account balance with China (Share of its GDP, in percent)



Source: Eurostat.

Table 1: The EU (external) and China's global market share in manufactured goods and commercial services (percentages)

		2007	2008	2009	2010	2011
Goods	EU	17	17	17	17	17
	China	12	13	14	15	16
Services	EU	20	20	19	19	19
	China	4	4	4	5	4

Sources: WTO Trade Statistics and Eurostat.

So far, so good. But the future looks less positive. The main reason is that Europe is losing competitiveness fast. Between 2000 and 2010, the complementary index for European and Chinese exports dropped by 20 percent.[1] This index is a very fine-calibrated method for calculating export performance. It shows that we are now in direct competition for at least 35 percent of 5,775 different kinds of goods, compared to 15 percent in 2000. A first glance at the 2-digit HS statistics of the UN Comtrade database, which encompasses 100 categories, reveals a huge leap in Chinese exports of electronic equipment and machinery. European exports did better in the car industry and pharmaceutical products, but in terms of trade volume these remained modest. For all other categories, export growth was similar. If we disaggregate the Chinese exports further, to the level of 6-digit HS categories, we no longer find a lot of basic goods, like textiles, among the best performing Chinese products, but a diverse number of household durables, high-tech components, as well as goods manufactured for the transport sector. Laptops and mobile phones from China accounted for the largest share, confirming the notion that its exports largely continued to be goods assembled with components from other countries to which not much value is added. As we know, only a small percentage of the retail price of a smart phone or a laptop ends up with Chinese workers, entrepreneurs or governments. Yet among the best performing products feature a lot of high-tech parts for mobile telephones, computers, photovoltaic systems, and other electronic products. Furthermore, we find cargo ships, scooters, and tanker ships. Europe retained its weight in the car, aircraft and pharmaceutical industries.

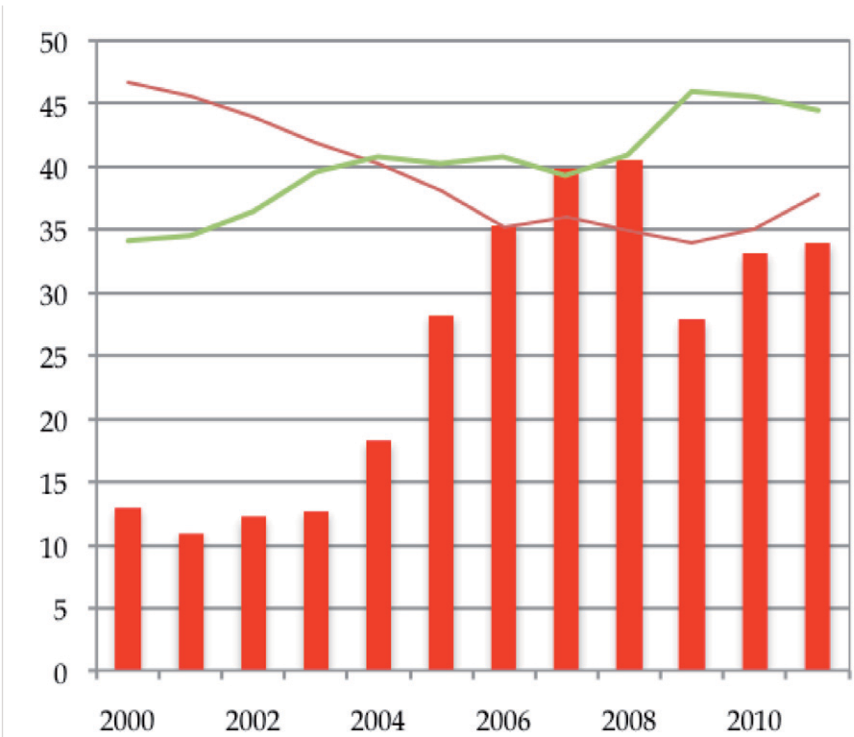
It is unlikely however that Europe will retain its position in those industries. Between 2000 and 2011, the number of person cars exported by China augmented from 5,000 to over one million, the quantity of car parts from 1 to 5 million tons, the number of planes from 50 to 176, and the value of medical instruments exported from US$3 million to over 4 billion. It is in the automotive industry that we can expect China to grow the quickest. China has ambitious plans to become a key producer of traditional cars, hybrids, public transport, and car parts. In the aircraft industry China has a much longer way to go, but here as well Europe will face more competition. While certainly not on a par with single-aisle Airbus variants, the C919 signals that China is rapidly moving forward. The same goes for the pharmaceutical business. Between 2000 and 2010, Chinese exports expanded by a meagre US$3.8 billion compared to Europe's staggering US$95.7 billion growth. Nevertheless the indications are that, as in other domains, China may make significant headway in the pharmaceuticals sector in the coming decade.

So, there is the risk of losing technological clout, which is as much the consequence of China's efforts as of Europe's failure to come up with a more effective innovation policy itself. As such, China's growing technological prowess is a challenge, not a threat. But it could become a threat as well. It can be argued that there would be room for

1. See Jonathan Holslag, 'Unravelling Harmony: How Distorted Trade Imperils the Sino-European Partnership', *Journal of World Trade*, vol. 46, no. 2, April 2012, pp. 221-38.

a number of high-tech powers on the global stage if the world economy moved back into healthy growth figures and if demand increased. This, however, cannot be taken for granted. If we are in for a long period of stagnation, as some predict, the contest for market share in high-tech will look more like a zero-sum game. This is likely to prompt the Chinese government to continue to go all-out in supporting exports. In other words, whereas most pundits in Beijing agree that export dependence needs to be reduced, social problems could drag the government into dangerous track dependency. There are several indications that this is going to be the case. Cheap capital continues to flow to national champions. More importantly, the 2 percent appreciation of the yuan against the euro since 2007 has been largely offset by the steep increase of export credit and concessional loans, which amounted to US$180 billion in 2011 (see table 2 overleaf). Chinese manufacturers are still very much dependent on exports and there is no evidence yet that this will change anytime soon (see chart 2 below).

Chart 2: China rebalancing? Export of manufactured goods as a share of total manufacturing



The red bars indicate output (in percent); the green and red lines indicate fixed capital formation and household consumption as a share of GDP (percentages)
Source: WTO statistics, UN Comtrade, and World Development Indicators.

Table 2: Chinese trade support (US$ billion)

	2004	2005	2006	2007	2008	2009	2010	2011
Trade credits	16	23	26	24	6	54	62	112
Loans	10	13	5	21	19	13	21	71

Source: SAFE.

The more unconfident China feels, the more it retreats into mercantilism and goes all out in backing its companies abroad. If the international and domestic economic climate improves, more reforms and opening-up are to be expected. Growing outward direct investment could also make China pay more heed to the calls for adjustment from partner countries. If things change for the worse, we are likely to see mercantilism on steroids, with more financial support to homegrown firms and industries, more aggressive diplomatic backing and more emphasis on indigenous innovation. The risk for Europe is that its main industries get exhausted in this economic battle of attrition, and that when China, at last, feels more confident, starts opening up, and preaching free trade, European companies will be too weak to benefit. So, the main challenge for Europe is uncertainty: we cannot take it for granted that China will accelerate economic reforms soon, which should induce us to strengthen our defences, but we should also not be fatalistic and bet everything on Chinese entrenchment.

Europe – addicted to debt?

But there is another side of the coin. As much as the Chinese government intervenes in support of exporting industries, European governments hamper economic rebalancing in favour of exporting companies. On the one hand, the euro has been overvalued by at least 15 percent for most of the last decade and this has not changed a lot since the advent of the crisis. A too strong currency, a too rigid labour market and an over-regulated services market have been the main causes of a current account deficit that exceeded 1.2 percent of our GDP and a net outflow of direct investments that amounted to another 1 percent of our GDP. The European Union is a good place to consume, but not to produce.

Table 3: Balance of payments in- and outflows as a share of GDP between 2007 and 2011 (percentages)

	EU-27	Eurozone
Portfolio investment	3.3	2.5
Investment income	-0.1	-0.1
Other investment	-1.6	-0.4
Current account	-1.2	-0.4
Direct investment	-1.0	-1.5

Source: Eurostat.

On the other hand, and this is related to what has gone before, governments have encouraged inflows of portfolio investment. While the UK has done so by positioning itself as a financial hub between Europe and the rest of the world, most other countries have done so by selling large amounts of bonds. In the case of the eurozone, 63 percent of portfolio investments since 2007 have been made in government bonds. In fact, the selling of government bonds abroad has contributed almost 2 percent to the eurozone's GDP since 2007. Whereas banks' gross external debt as a share of the eurozone's GDP decreased from 58 to 48 percent, governments' external debt increased from 14 to 25 percent, bringing total gross external debt to 121 percent of the eurozone's GDP. Government bonds have become the main 'export product' of the eurozone and probably even of the European Union at large. This pushes up the euro even more, drives down internal interest rates, and dissuades investment in sectors that are needed to trim the current account deficit.

Table 4: Gross external debt of the eurozone as a share of GDP (percent at year-end)

		2007	2011
Portfolio investment	Government	14	25
	Banks	58	50
	Companies	24	28
Direct investment		14	15
Other investment		4	2
		114	**121**

Source: ECB Statistical Database.

The pot calling the kettle black: twin distortions

When it comes to Sino-European economic relations, the pot seems to be calling the kettle black. The trade imbalance is a common responsibility and neither side is making enough efforts to remedy the situation. This debt trap is a disaster for Europe's competitiveness in the long run. Yes, the financial crisis has had some downward effect on the euro, but not to the degree that it has helped address our overconsumption. In the end, if the international climate continues to deteriorate, two things are liable to happen. The first is a competitive devaluation of the dollar with the RMB still pegged to it, which would deal another blow to European industries. The second is more protectionism, which will close another door to rebalancing. What complicates the situation even more is that the European Union has not enough institutional wherewithal to deal with these likely challenges.

Europe's economic policy seems to be cruising on auto-destruction mode. The economic crisis has set in motion several important reforms, but these will not be sufficient and, with the growth of external debt, a significant part of the adjustment cost is pushed forward to the next generation. In fact, Europe seems to be implementing the very macro-economic and monetary policies that the US is now trying to end, because they proved disastrous to its competitiveness. European leaders might assume that with the transformation of the Chinese economy, Europe can reduce its external debt by banking on growing Chinese demand. The current crisis, some argue, is not the right moment to devalue or to dissuade portfolio investment. It is better, the reasoning continues, to defer more difficult macro-economic adjustments until the international context is more favourable and developing countries like China shift to pro-consumption policies.

This is the uttermost folly. First, it remains highly uncertain how China will develop. Nobody can say whether it will push through to the primary league of advanced economies or whether it will languish among the middle-income countries. Second, Europe might first have to withstand a decade of cut-throat competition and mercantilism, so that it may not have much industry left to benefit from growing demand elsewhere. Third, the negative investment climate in Europe will cause a drain of productivity, knowhow and human resources, and, ultimately, push production chains to the East. Fourth, and consequently, if adjustment is postponed too long, Europe will have to replace its overconsumption by economic activities that might be less productive, less profitable and less attractive than activities that it might otherwise have pursued had it not been eclipsed by Asia in the high-tech sphere.

What next?

In both scenarios – Chinese success or disappointment – Europe's trade policy towards China needs to be embedded in an economic strategy that prunes back external debt and deals convincingly with the overvalued euro. European economic diplomacy towards China has the following urgent tasks:

1. To manage China's clever economic brinkmanship. Too often, Beijing buys time in negotiations about unfair competition and manages to push them to the point where Chinese companies have exhausted most of their privileges, and those privileges have hence become less relevant, or where the Chinese firms have acquired all the capabilities to outstrip European peers – both domestically and abroad.

2. To pool resources with the member states so as to map Chinese export credit policies in various parts of the world. Negotiations with the US did seemingly prompt Beijing to change its credit policies and export credits dropped significantly in the first quarter of 2012, but that was offset by a major increase in the second quarter.

3. To adhere to a policy of strict reciprocity in the services sector. The services sector is by far the most important component of the European economy. If Chinese companies are allowed to access this market without full access of European companies to the Chinese market, we risk creating another major drain on the balance of payments.

4. To put the general interest first and not have trade policies guided by the aspirations of a limited number of large investors in the Chinese market. While growing, investment incomes from China still represent a minor part of the current account. What matters most is the position of companies that produce and develop services inside Europe. Those are often more fragmented and less well represented. The European Commission should actively reach out to such companies and support them to document the impact of China on their revenues. The creation of anti-dumping investigation groups is a good initiative in this regard.

5. To persist in *ex-officio* investigations, even if some member states obstruct such initiatives. The Commission needs to make its cases forcefully, allow some time for settlement, but then act with vigour and anticipate countermeasures.

6. To call a halt to the free-trade fetishism in Brussels that makes any rational debate about Europe's interests in an uncertain economic order impossible. Officials dealing with trade should recognise that free trade is superseded by politics from the very moment that governments sell bonds, set interest rates, and influence the currency rate. Those policies often have a more distorting effect than the very specific industrial strategies or trade barriers on which we usually concentrate.

7. To strengthen the High-Level Economic Dialogue with China. Besides discussions on trade issues, mixed working groups should report to the dialogue on possible co-ordinated strategies to redress imbalanced growth, to work towards more economic stability, and even on ways to concert on international challenges.

The baseline for all this remains that Europe has a clear interest in expanding its economic partnership with China. Protectionism and a trade war are certainly not the most effective options to advance our economic interests. Yet, if rebalancing between the two economies does not progress, if the international economy enters into a protracted period of slowdown, and if Europe continues to be unable to implement a more assertive monetary policy, a tougher trade strategy will become an unavoidable tool to provide some protection to Europe's declining economy.

THE VIEW FROM THE EU

Antonio Parenti[1]

Jonathan Holslag's paper as usual provides not just food for thought, but a full meal on one of the contemporary world's most complicated political and economic relationships. This relationship between 'old Europe', in decline and incapable of defining its place in the world, and 'the new kid on the block', eager to regain the place in the world that was that of his ancestors, is one that is often viewed with apprehension.

Holslag explains the rationale behind such apprehension in terms of China's growing economic and technological clout: China is no longer simply resented for taking low-skilled jobs out of Europe; it is also perceived more and more as a threat to our longstanding technological superiority. This is now made an even more clear and present danger by Europe's growing external debt and the explosion of the financial crisis which are not only preventing Europe from cushioning China's rise, but are also offering China further opportunities to penetrate European markets.

What Holslag infers from all of this is Europe's clear failure to pursue a 'realistic' economic diplomacy *vis-à-vis* China: i.e., Europe's incapacity to combine 'the pursuit of economic opportunities with measures designed to fend off foreign challenges to the national economic interest'.

It would be easy to dismiss this view by arguing that it is impossible for an entity like the European Union to pursue a 'realistic' foreign policy in the economic sphere because the EU by its nature is not predisposed to such a foreign policy approach, nor does it have all the necessary instruments at its disposal to conduct such a policy.

To do so, however, would be a mistake because China is exposing like no country ever before the shortcomings of the European construction project, even after the Lisbon Treaty. The economic, political and even military clout of the EU is still too fragmented for a growing China to feel that it needs to seek compromises with the EU. The EU, the champion of soft power (and an effective one in Europe for sure), on the other hand, is left only with the 'hard powers' of its trade and competition policies: we cannot pretend that they supplement all the others (even if they could be used more effectively if EU member states managed to develop a more coordinated approach *vis-à-vis* China) and achieve the objectives that Holslag, rightly, considers should be pursued by the EU.

1. Deputy Head of Unit – Trade Relations with the Far East, DG Trade, European Commission. The views expressed in this article are those of the author and do not represent the views of the institution for which I work.

In addition the effectiveness of these powers *vis-à-vis* China has been somewhat undermined by the current financial crisis as it has exposed the differences between member states and allowed China to take advantage of possible divergences and rifts among them. We will return to this point at the end but it is clear, as Holslag notes, that resolving the current financial crisis is important not only for the European economy but also for Europe's status and effectiveness in the world.

Against this background, is China the threat that Holslag describes in his paper? Yes and no.

First, we should not necessarily be worried by China's economic rise and increasing competitiveness. The European economy has grown for most of the last sixty years thanks to and in competition with the US economy and both the EU and the US have dramatically benefited from this state of affairs. The emergence of a third world pole of growth should, if anything, have positive repercussions for all the actors concerned and, if China could decouple from the US and EU economies, it could offer an additional buffer at a time of crisis in Europe and in the US. This has already happened to some extent during this crisis, as demonstrated by the resilience for example of the German economy due to sustained demand in China.

Second, Chinese investment in Europe, like any foreign direct investment, tends to be beneficial for all the actors involved. And, at the risk of sounding like too much of an economic liberal in my views, where is the danger if a Chinese company becomes a world competitor by acquiring some European companies?

Third, while it is true that China is getting bigger and more competitive it is not yet the only place in which to do business in the world. For example, every year US companies invest more in Ireland than in China!

However, although we should not overestimate the Chinese 'threat', we should not take it lightly either. Much will depend on how China will evolve politically and, by extension, economically under its new leadership. When I noted above that the EU and US economies have competed with each other for the last sixty years to their mutual benefit, I did not specify (although the idea was firmly present in my mind) that these were democracies run by the rule of law. Not all has been perfect in those years but the US and the EU were substantially open to each other and we could legitimately have recourse to the judiciary, including at international level, when either side was playing foul games.

It is by no means certain that China will evolve in that direction and this will have important economic implications. It would clearly be unacceptable for a China intent on boosting internal consumption and on track to becoming the most important market in the world, to do so by excluding or clearly predetermining the space that foreign goods or foreign companies could have in the Chinese economy. China's drive towards economic modernisation has been a major undertaking and Chinese industrial policy cannot be dismissed as purely protectionist, but the level of economic development already achieved is such that certain past practices (non-respect of IP rights, massive state subsidisation, stringent limits on foreign investments, to name just a few) are no longer excusable.

What is Europe to do in these circumstances, and in particular how should it conduct its trade policy? The goal of our trade policy *vis-à-vis* China is to open up China, not to close Europe. The most important prerequisite for achieving this result is unity in Europe. This is not easy in the current difficult economic times, but disunity comes at a longer term cost for all.

Second, while waiting for the EU to be capable of pursuing a realistic economic policy, as Holslag notes, we should show China our resolve when necessary. The EU is doing this, albeit reluctantly, but we should not overestimate the possible benefits of such actions. Probably, as our capacity to really influence the direction of internal reform in China is limited, the EU should concentrate on finding alternatives to China both in terms of production outlets as well as end markets. Here we are moving in the right direction with the web of agreements being negotiated in Asia and possibly soon with Japan and the US.

Finally, I agree with Holslag that the EU should reinforce its High-Level Economic and Trade Dialogue (HED) with China. This will require on the EU side the capacity to identify positive deliverables for China through that dialogue; otherwise the dialogue will just continue to take the form of two monologues and thus be ineffective. Certainly, until these are identified the way in which the dialogue is structured on the EU side, and the lack of proper coordination of EU bilateral economic relations with China, is clearly hindering rather than helping the effectiveness of the HED and, more generally, of EU action in China.

II. INVESTMENT

EU-CHINA INVESTMENT RELATIONS

Jonas Parello-Plesner

Introduction

Like most foreign investors, China worries about the ramifications of the eurozone crisis. However, Chinese companies have also perceived the crisis as an opportunity to directly invest in and buy European companies, thereby contributing to a huge increase (albeit starting from a very low level) in Chinese investment inflows. This fits with a new phase of the Chinese 'going out' investment strategy and China's aim to move up the value chain. Yet the European market also poses challenges for Chinese firms due to their unfamiliarity with local conditions. Applying Chinese investment patterns imported from other regions to the European market is also problematic.

Today, the EU possesses a mandate to negotiate investment agreements on behalf of the member states. A new investment treaty between the EU and China that is currently being discussed could open up avenues for further market access to European companies in China as well as expanding the scope of investment protection.

This presents an opportunity for the two economies to move to a new level of interdependence. But the whole issue of investment is complicated by sources of friction regarding questions of national security and the opacity in China's state-owned company structure that could lead to an increase in protectionism on the European side if they are not properly addressed.

Chinese investments and the euro crisis

Nowadays, whenever the EU is mentioned, the spectre of the ongoing eurozone crisis is never far from people's minds. This also goes for the Chinese. China – just like the rest of the world – has closely observed recent European stop-and-go approaches to solving the crisis. China's state bankers still demand triple AAA ratings with long-term sustainability. Thus, highly indebted European countries have not been the destination of choice for Chinese state-funded investors.[1]

1. There is a fundamental opacity in the area of Chinese bond purchases in Europe where neither member states nor the ECB tracks such purchases. Still, what can be inferred is that China has not become the 'red knight' of the eurocrisis. See Yu Yongding, 'Beijing will not ride to eurozone's rescue', *Financial Times*, 31 October 2012. See also the author's testimony to the US Congress available at: www.uscc.gov/hearings/2012hearings/written_testimonies/12_4_19/Parello-Plesner.pdf.

On the other hand, the eurozone crisis has created new opportunities for China and Chinese companies in the EU regarding direct investments and mergers and acquisitions. This ties in with Chinese ambitions for its next phase of growth based on innovation and high and green technology. A striking example is the automobile sector, where Rover Group (with well-established brand names such as MG) is now owned by the Shanghai Automotive Industry Corporation while Volvo is owned by the Chinese Geely Automobile Holdings. The Chinese also have a stake in what remains of the Swedish group Saab. The Chinese carmaker, Great Wall Motors Company, is also setting up local production in Bulgaria.

Some Chinese investments have also been a direct consequence of the crisis in the eurozone. For example, Three Gorges Corporation, a Chinese state-owned company, bought a stake in Portugal's energy company, EDP, when the government's stake went on sale to comply with austerity cuts in accordance with EU demands. Paradoxically, economic theory would normally hold that state assets are sold off to private investors to increase efficiency. In this case, another state-owned Chinese company just took over.

This also goes for infrastructure projects where Chinese companies are seeking to enter European markets. The most emblematic and now infamous example was the bid by the Chinese consortium, COVEC, for the construction of a stretch of the A2 highway in Poland. In 2009, the Chinese were awarded the contract after putting in a bid that was much lower than those of their European competitors. However, in 2011 COVEC pulled out of the deal with an official explanation of soaring costs.

Other explanations of the background to this aborted project are a lack of knowledge of local conditions including labour costs, where the traditional Chinese formula of bringing in scores of Chinese workers could not be applied, as well as rules on social and environmental standards (a rare local species of frog that had to be protected was something that the Chinese company had not reckoned with). Also, undoubtedly a certain element of hostility and resistance to the Chinese entrepreneur played a part, manifest in price hikes introduced by local and other European subcontractors.

Nevertheless, the Chinese appear to be willing to continue to get involved with infrastructure projects. The recently established secretariat for Eastern and Southeast Europe (16 countries, including both EU and non-EU member states) run by China's foreign ministry establishes drawing rights from a credit line of 10 billion USD aimed at infrastructure projects.

In that regard, it is important to explain EU-wide standards on public tenders, and the fact that these are assessed as part of an open and transparent process, to the Chinese – as well as the fact that infrastructure investments cannot be linked to favourable loan financing as has been Chinese practice in other continents.[2]

2. For example, the minerals-for-infrastructure swap between China and the Democratic Republic of the Congo (DRC). See analysis by Johanna Jansson, of Roskilde University, available at http://congosiasa.blogspot.dk/2011/11/guest-blog-taking-stock-of-china-deal.html.

So far, there is no concerted EU strategy on attracting Chinese investments. Each member state deals with the Chinese bilaterally and on its own terms. The Chinese reciprocate by prioritising relations with member states where deals are struck and have even, as in the case of Eastern Europe, set up their own regional format inside the EU with that purpose in mind.

Chinese investments moving to the developed world and the EU

The world has watched Chinese companies move abroad in the last decade in greater numbers, seeking in particular opportunities in the field of energy and resources and mostly targeting other developing markets. The next phase of China's 'going out' strategy appears to be targeting developed markets. In this context, Europe is important for this new stage of China's economic development, i.e. moving up the value chain and looking for investment options in high and green technology, and buying into established brand names and business know-how and supply chains.

Still, access to resources is also important in the developed market. The US$15 billion takeover by CNOOC, the Chinese oil giant, of the Canadian resource company Nexen illustrates this newer trend as well as China Investment Cooperation's recent US$3.2 billion stake in the French company Gaz de France (GDF).

A report published by Asia Society in 2011 predicts that Chinese outbound investments are likely to rise to one trillion dollars towards 2020, with the greater part directed towards developed markets such as the EU and the US.[3] That would indicate that the EU would receive cumulatively at least US$250 billion in this period.

Numbers matter

Still, how much are we talking about right now when it comes to assessing Chinese investments in Europe?

Chinese investments start from a very low level in Europe compared to Foreign Direct Investment (FDI) inflows from the rest of the world. In 2010, China's outward Foreign Direct Investment (OFDI) was equal to Sweden's and China's OFDI-to-GDP ratio is only 5 percent.

There is agreement on the fact that Chinese investment in Europe is rising fast. Beyond that, there is a considerable amount of discrepancy in official numbers. According to the Chinese Ministry of Commerce, Europe was the region with the largest

3. Daniel H. Rosen and Thilo Hanemann, 'An American Open Door? Maximizing the Benefits of Chinese Foreign Investment', Center on Us-China Relations, Asia Society, and Kissinger Institute on China and the United States,Woodrow Wilson International Center for Scholars, Special Report, May 2011. Available at: http://asiasociety.org/policy/center-us-china-relations/american-open-door.

investment intake from China and a year-on-year growth of 26.8 percent amounting to USD 7.5 billion in 2011.[4] A report by the Rhodium Group puts the number even higher at above 10 billion for 2011.

Both Eurostat and the Chinese Ministry of Commerce publish official numbers. Yet, they do not paint the same picture. Generally, Chinese official statistics do not capture the final destinations of FDI flows where most first transit to Hong Kong or to islands in the Caribbean known for their status as tax havens. According to Chinese official statistics, Luxembourg is also a major destination for Chinese FDI in Europe due to the financial services offered there facilitating investments, yet this is often not the final destination for a given investment.

And at country level the discrepancy can get even larger. Based on such official numbers, a European China Research and Advice (ECRAN) paper concludes that Denmark is a front-runner in attracting Chinese FDI.[5] Exactly the opposite conclusion is reached by another report that marks out Denmark as punching way below its weight compared to FDI rankings from the rest of the world.[6] Talks with Danish officials in Invest in Denmark confirm the latter picture and they perceive themselves to be behind other comparable countries in attracting Chinese FDI, notably Sweden.

The European Commission has recognised this discrepancy and has commissioned a private consultancy firm to provide a fuller picture of Chinese investment inflows. However, this research also draws on other already available resources. Reporting is done by a consultancy firm, Thierry Apoteker Consulting (TAC) under the EU-China Economic Observatory and based on data presented by Reuters' ThomsonOne for M & A and by the FDI monitoring database FdiMarkets operated by the *Financial Times* for greenfield investments.

Another method is to go from the bottom up and assemble numbers on deals conducted in member states. Such an approach overcomes the problem of re-routings through offshore destinations – a common difficulty with Chinese investments abroad. The European Council on Foreign Relations (ECFR) used such an approach in a report on Chinese investments in Europe published in July 2011.[7] Based on the same bottom-up approach, a newer and more complete picture covering all member states was undertaken by the Rhodium Group in their recent report from June 2012.

4. See: http://www.mofcom.gov.cn/aarticle/ae/ai/201208/20120808313286.html.

5. See Jeremy Clegg and Hinrich Voss, 'Chinese overseas direct investment in the European Union', ECRAN working paper, 2012.

6. See table 2, p. 38 in Thilo Hanemann and Daniel H. Rosen, 'China Invests in Europe Patterns, Impacts and Policy Implications', June 2012, available at http://rhgroup.net/wp-content/uploads/2012/06/RHG_ChinaInvestsInEurope_June2012.pdf.

7. See François Godement and Jonas Parello-Plesner with Alice Richard, 'The Scramble for Europe', European Council on Foreign Relations, July 2011. Available at http://www.ecfr.eu/page/-/ECFR37_Scramble_For_Europe_AW_v4.pdf.

There is also the complicating factor of a looser and broader definition of Chinese capital inflows versus a stringent definition of FDI. When politicians and the media refer to Chinese capital inflows they tend to use such a broader definition rather than the rigorous academic definitions of FDI inflows. For example, the much-talked about port buy-up in Piraeus, Greece, by the Chinese shipping company COSCO in 2010 was actually a long-term lease and thus does not figure in official FDI statistics. Likewise, the academic 10 percent ceiling on the classification of FDI excluded the 9 percent stake by China Investment Corporation (CIC) in Thames Water, the British utility company, which clearly constituted a large inflow of Chinese money and was reported widely in the press.

Finally, it is difficult to obtain exact data on Chinese portfolio investments. Interviews with German business leaders indicate that they are aware of minority holdings by several Chinese investors whose levels of investment are such that they are not required to disclose their identity.[8] All in all, the EU should step up its game on numbers in the interests of clarity and transparency.

Areas of tension

FDI inflows are an important part of a globalised world characterised by large-scale capital movements. Growing Chinese investment in Europe comes at a time when European companies need capital inflows. Thus, there is a large potential for Chinese investments.

There are also areas of tension that need to be addressed and various options whereby the EU can strike a better deal with the Chinese, in particular regarding European access to Chinese domestic markets.

The question of job creation as a result of inward investment in a context of austerity and mass-scale unemployment in the EU is of particular importance. Most European countries seek greenfield investments, where a local subsidiary is opened, as these tend to lead to the creation of new jobs. However, most Chinese investors are looking to acquire well-established brands, as the cases of Volvo, Rover and Saab show in the automotive sector. And this is done through mergers and acquisitions (M & A), where job creation is less certain. For example, when a Chinese firm acquired part of the wind turbine manufacturer Vestas, the Danish Minister for Trade and Investment, Pia Olsen Dyhr, keen to attract job-creating investments, commented positively that 'at least we are preserving jobs'.[9] Yet with a takeover, additional employment does not necessarily follow. A takeover can also lead to job losses.

8. Interviews conducted by the author for the policy paper, 'China and Germany: the emerging special relationship', European Council on Foreign Relations, May 2012. Available at http://ecfr.eu/page/-/ECFR55_CHINA_GERMANY_BRIEF_AW.pdf.

9. See: http://borsen.dk/nyheder/politik/artikel/1/234954/hu_jintaos_besoeg_har_allerede_givet_bonus.html.

So far, the share of Chinese investments in Europe is still too small to draw definite conclusions on this. There have been fears of predatory investment practices whereby factories and technologies are quickly repackaged to China, but so far that has not been a prevalent trend. Volvo has actually increased its workforce in Sweden since the merger with Geely. Huawei, however debated its brand name is, actually employs more than 5,000 people in European countries. Still, this question is likely to dominate political debates about Chinese investments in member states. On the Chinese side, companies need to convince Europeans about their long-term investment strategy and beneficial spinoff effects in terms of local employment.

There is a minor although not negligible question of national security concerning investments. The US has a foreign investment screening process. China has recently introduced a similar system in its legislation. The EU does not have such a system in place at the European level and only some member states have national procedures. Currently, there is a lack of clarity in the EU on such screening, although the EU appears, with regard to this parameter, as the most open of the three large world economies. It is important that the EU maintains this level of openness.

Still, a simple vetting system administered and enforced at the European level that covered national security would clarify matters for Europeans and Chinese investors alike. Such a system would have to be based on a stringent definition of national security so that it would not create unnecessary obstacles to inward investments based on broader questions of economic security. Nor should this be left to the discretion of member states as there could be differences in national implementation leading to a lack of clarity. There have been calls for such a system by Commissioners Tajani and Barnier yet the internal discussions in the Commission as well as attitudes in member states make it unlikely that such a European instrument will be adopted anytime soon.

Related to this is the question of the origin of Chinese companies. Most of the investment (around 72 percent) flowing into the EU originates from state-owned enterprises (SOEs). However, looking at the total number of investment transactions, the Chinese state only accounts for one-third so there is a growing Chinese private entrepreneurial capacity at play as well in Europe.

State-owned companies are by their nature linked to the Chinese government apparatus and their top CEOs are hired and fired by the Communist Party's organisation department. These hybrid entities pursue commercial objectives but are subject to political guidance, and are thus met with some scepticism in Europe. Inside the Chinese system, these companies are shrouded in a high degree of opacity and many ordinary Chinese citizens clamour for more information about how state funds are channelled into SOEs, particularly since salary levels are considerably higher in such entities.

Thus, Europe must set high standards for transparent corporate governance based on OECD and other guidelines to ensure that this culture of opacity is not imported by Chinese SOEs into the EU. Competition policy could also play a role in this in cases of mergers and acquisitions.

Simultaneously, a special effort should be made to welcome Chinese private enterprises that often do not benefit from the Chinese state's support in their 'going out' ventures and thus need even more nurturing to enable them to understand the rules and market conditions inside the EU. This will also strengthen Chinese private capital on home ground. Likewise, the EU and member states should coordinate the strategies deployed by national investment agencies and other government organs to attract foreign investors to ensure that the level playing field is maintained. Naturally, there will be a continuing element of competition in attracting Chinese investments yet it is important that this does not lead to lowering the bar on joint rules. For example, efforts to attract Chinese investors to Sweden led to a number of Chinese companies being set up that in reality were a front for illegal immigration operations.[10]

There is also a danger that the Central and Eastern European secretariat established at the Chinese foreign ministry may link access to loans with concessions on infrastructure deals – something that would be a departure from the EU's strict rules on public procurement and tender procedures.

Therefore, there could be more of a concerted effort on the European side in explaining the rules of the game for investing in Europe. For Chinese investors, it can be a bureaucratic jungle with a whole panoply of environmental, social and labour legislation to take into account. Chinese companies as in the COVEC case can seriously misestimate costs and local conditions if they are not properly informed. It will be a steep learning curve for Chinese companies to fully integrate into developed markets such as the EU but here a more coherent effort could be undertaken on the EU side to facilitate Chinese investors.

On the other side of the coin, European companies have been investing massively in China for a number of years. They are campaigning for more market access and less stringent rules on teaming up with joint ventures. The post-Lisbon Treaty EU has enhanced competences in investment policy. The EU is now seeking to negotiate a new investment treaty aimed at obtaining greater market access for European companies in China. China is interested in such a treaty since it could offer investment protection at a time of growing Chinese investment in Europe: such cases as the losses incurred by the Chinese insurance firm Ping An from its investments in the Belgian bank Fortis still rankle with the Chinese.

10. See articles by the Swedish journalist, Ola Wong, available at http://olawong.squarespace.com/ola-wong/2011/7/15/invest-sweden-gravet.html.

In negotiating the investment treaty, the Commission should naturally be in the driver's seat but it would be helpful if member states backed up on this in their bilateral dealings with China, so that it would be seen as a joint push. Instead member states mostly focus on seeking short-term business deals, whereas jointly improved market access would provide the leverage that could sustain more European exports and investments in China in the years to come.

What next?

The eurozone crisis has given an extra impetus to Chinese investments in the EU. It is the beginning of a fast-growing trend and has created a new financial umbilical cord between China and Europe. The new wave of outbound investment is also a natural development for the world's second-largest economy that can contribute positively to growth and employment in the European economies. This rapid move into European acquisitions could well be the most startling change in the relationship between the EU and China in recent years. After a deal with China Investment Corporation (CIC), the head of the Polish Investment Agency remarked with regard to the size of future investments that 'the sky's the limit'.

The EU also needs to do its homework and provide precise figures for Chinese FDI in Europe so that the debate is grounded in up-to-date facts. As explained above, unresolved points of tension remain, and Europe should take a proactive stance in order to ensure better market access in China as part of negotiating an investment agreement. Critically, this agreement needs to ensure that Chinese investments in Europe do not import lower standards of corporate governance. It should also set clear limits on questions of national security.

THE VIEW FROM THE EU

Felipe Palacios Sureda[1]

Following the entry into force of the Lisbon Treaty in 2009, the Commission Communication on the future European investment policy in July 2010[2] identified China as a potential partner with whom the EU could pursue negotiations for a stand-alone investment agreement. In order to assess the desirability and feasibility of such negotiations and the economic, social and environmental impact of a potential agreement, the Commission services concluded an impact assessment study which points towards the benefits of an ambitious and balanced EU-China investment agreement. At the 14th EU-China Summit in February 2012, leaders agreed to move towards negotiations on an investment agreement covering all issues of interest to either side and this willingness was confirmed at the 15th EU-China Summit. The Commission will in due time come forward with a proposal to the Council for negotiating guidelines.

The impact assessment study considered the views expressed by a wide range of stakeholders, including member states, civil society, industry and NGOs following a set of civil society dialogues, public consultations and an extensive business survey among firms in the EU and European firms in China. There was a general convergence of views that China is an increasingly strategic market for European investors and there was strong support for an EU-level initiative to facilitate investing in China and improving legal certainty for European investors.

Consultations also concluded that several factors hindered or complicated investment in China. Problems mentioned range from licensing and joint venture requirements to subsidies, the conduct of state-owned enterprises, unfair and discriminatory treatment and the lack of legal certainty in China.

The study looked at the EU-China investment climate and identified a number of problems. These included the lack of a level playing field for prospective and existing European investors in China and the lack of a comprehensive framework to remedy shortcomings in the EU-China investment relationship. It also took into consideration China's and the EU's bilateral agreements and negotiations with third countries and their implications for investment. In particular it focused on the EU business and legal environment for Chinese investors and the concerns linked to Chinese investments in the EU.

1. Investment Affairs Manager in Investment Unit-B.2. at DG Trade in the European Commission. The views and opinions expressed in this article are those of the author and do not in any way represent the official view of the European Union and the European Commission.

2. Communication from the Commission to the Council, The European Parliament, The European Economic and Social Committee and the Committee of the Regions, 'Towards a comprehensive European international investment policy', COM (2010) 343, Brussels 7 July 2010.

The EU's main purposes for these negotiations should be the progressive abolition of restrictions on trade and foreign direct investment as well as promoting the Union's general external action principles and objectives. In practical terms the main objectives of an agreement would include improving legal certainty regarding the treatment of EU investors in China, improving the protection of EU investments in China, reducing barriers to investing in China, and increasing bilateral investment flows.

A number of policy options were considered and the potential impacts of the options were analysed including economic, environmental, social and human rights aspects, impacts on the states' right to regulate as well as administrative and budgetary impacts. The study finds that the conclusion of an investment protection and liberalisation agreement would address the purpose and objectives of the EU and would have a positive overall impact for both the EU and China. It would enhance legal certainty for the treatment and protection of EU investors in China and in the EU, create additional market access and increase investment flows between the EU and China. It would also deliver the highest welfare gains, address current imbalances in the EU-China investment relationship, and have a marginal positive environmental as well as employment impact. In sum, the study and consultations confirmed that the main added value of an EU-China Investment Agreement resides in further investment liberalisation, leading towards reciprocity in access for EU and Chinese investors to each other's markets.

Following the conclusion of the study late in 2012 the Commission is considering its recommendation to the Council and the negotiating directives that it should prepare. Timings have not yet been decided.

III. THE EURO AND GLOBAL ECONOMIC GOVERNANCE

CHINA, THE EURO AND THE REFORM OF THE INTERNATIONAL MONETARY SYSTEM

Miguel Otero-Iglesias

Introduction

Against the backdrop first of the global financial crisis that erupted in 2007-8 and then of the ongoing eurozone sovereign debt crisis, two themes have been high on the agenda of Chinese and EU policymakers: (i) the reform of the international monetary system and (ii) the survival of the euro. While EU officials have been concerned with the former topic for decades, it is only quite recently that their Chinese counterparts have stepped into the spotlight. China's intervention was signalled by the much debated 2009 speech by the Governor of the People's Bank of China, Zhou Xiaochuan, calling for the reform of the international monetary system.[1] Zhou's words triggered a flurry of responses. US officials registered disquiet, the Europeans politely took note of Zhou's remarks and the BRICS rallied behind Beijing's calls for reform. Nicolas Sarkozy seized upon the issue and announced that the reform of the international monetary system (IMS) would be the main priority during the French presidency of the G-20 and G-8 in 2011.

Zhou's central argument is not new. The Europeans have been struggling with it for decades. The current IMS is undermined by an inherent flaw known as 'the Triffin dilemma'.[2] In order to issue the necessary liquidity in dollars to the rest of the world, the US needs to run persistent current account deficits. However, if these deficits become too large (generating unsustainable global imbalances) the credibility of the dollar as the monetary anchor of the system starts to erode. In the current flexible dollar standard regime (based on fiat money) the sustainability of the IMS is based on faith. Economic actors around the world need to believe that the US will be able to meet its external debt obligations. Once this central assumption is called into question, the whole edifice starts to look like it is on shaky ground, as is now the case. The possibility of the US monetising its debt (through quantitative easing, for instance) has worried policymakers in Beijing for some time, and this is why they

1. Zhou Xiaochuan, 'Reform of the International Monetary System', Speech, People's Bank of China, 23 March 2009. Available at: http://www.pbc.gov.cn/english/detail.asp?col=6500&id=178.

2. The 'Triffin dilemma' or 'Triffin paradox' was first identified by the Belgian economist Robert Triffin (1911-1993).

have always welcomed the euro as a way of diversifying their currency holdings away from the dollar. For them, the European single currency has the potential to function as a counterbalance to US dollar hegemony in monetary affairs.

This view has been maintained, and reinforced, throughout the eurozone sovereign debt crisis. In stark contrast to widespread euro-scepticism coming from Anglo-American financial institutions, Beijing's approach has been consistently 'euro-optimistic'. China has on numerous occasions declared that it would be willing to provide financial assistance to debt-stricken eurozone member states. However, how much help did it really provide? What is the actual share of euro-denominated assets in China's portfolio? And more importantly, if this offer of help is genuine, how should Europe react? Does this bring Europe and China closer together on the question of the reform of the IMS? In an attempt to answer these questions, the first part of this chapter will focus on China's investment in euro-denominated assets, the second on existing Sino-European collaboration on the reform of the IMS and the third on how this partnership can be improved to safeguard European interests.

China's support to the euro

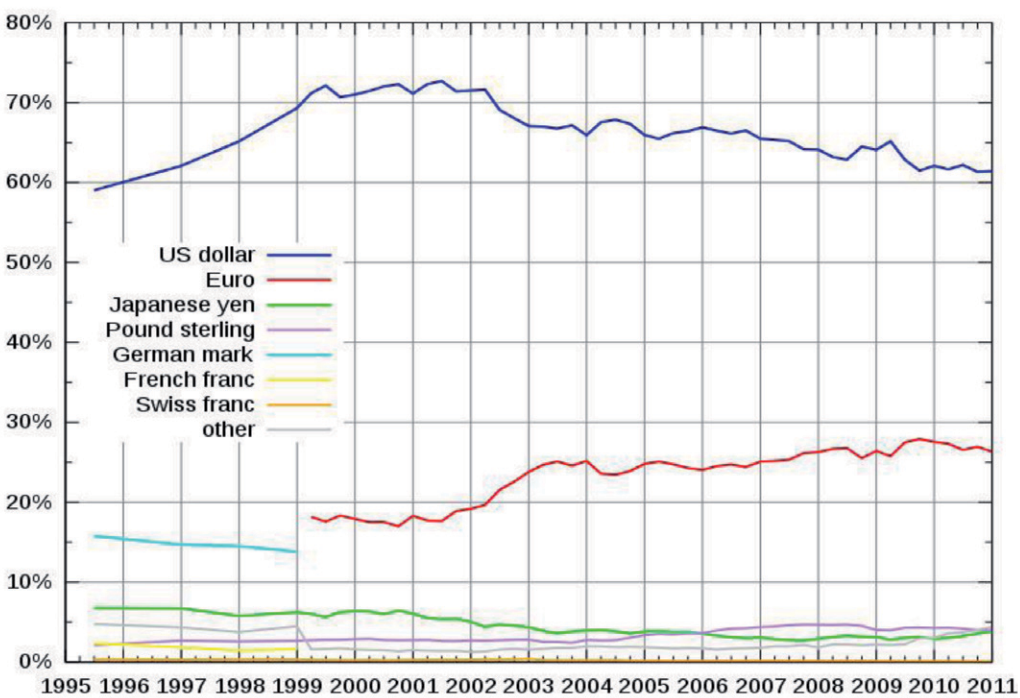
China's vocal support to the euro has not faltered since the inception of the European common currency. Chinese policymakers have always praised the euro as the symbol of European integration and as an important stepping stone towards a more balanced and therefore more stable IMS, countering the hegemony of the dollar. They have also openly declared that China would diversify part of its foreign reserves (US$3.3 trillion by the end of 2012) out of the dollar and into the European common currency. This trend has been reinforced since the onset of the eurozone debt crisis. Chinese officials have in fact regularly announced that they would buy euro-denominated debt instruments from both the eurozone core and the peripheral countries. These purchases have been confirmed by EU officials, especially from the eurozone periphery, who have been keen to show to the markets that China was investing in their countries. However, how much of Beijing's foreign reserve portfolio is denominated in euros? This is a difficult question to answer since the currency composition of China's reserves is considered a state secret and as such is not included in the IMF's Currency Composition of Official Foreign Exchange Reserves (COFER) database. Data from EU member states are not available either. Unlike the US, European countries do not disclose the buyers of their sovereign debt. This makes some European analysts sceptical about China's 'helping hand' during the euro debt crisis.[3] They reckon that China is using 'bond diplomacy' to increase its political leverage in Europe at very little cost. Others are more optimistic, believing that China has effectively used the

3. François Godement and Jonas Parello-Plesner with Alice Richard, 'The Scramble for Europe', ECFR *Policy Brief* no. 37, July 2011. Available at: http://www.ecfr.eu/page/-/ECFR37_Scramble_for_Europe_AW.

euro crisis to diversify further into the euro, pushing the European common currency's share in China's reserves portfolio up to almost one-third.[4]

This data presented here is based mostly on anonymous interviews with Chinese officials in Beijing in 2009 and 2012, suggesting that the euro's share in China's portfolio went from 26 percent in 2010 to 30 percent by the end of 2012. The 2010 figure used here is consistent with the findings published in the *China Securities Journal*, an official publication, where unnamed managers from the Chinese State Administration of Foreign Exchange (SAFE) disclose that at the end of the decade China's reserves were roughly similar to the global average: 65 percent in US dollars, 26 percent in euros, 5 percent in British pounds and 3 percent in Japanese yen (see Figure 1). This figure is consistent with the author's findings collected during field research and interviews in China.

Figure 1: Global distribution of global foreign exchange reserves



Source: COFER, IMF

4. Nicola Casarini, 'For China, the euro is a safer bet than the dollar', Analysis, EUISS, Paris, June 2012.

In June 2011 and March 2012, respectively, analysts at Standard Chartered Bank and *The Wall Street Journal* confirmed that China was diversifying its new flows (although not its stocks) of foreign exchange reserves into the euro.[5] Taking their calculations into account, and triangulating them with my own interviews in Beijing, I am of the opinion that by the end of 2012 the share of the euro in China's overall portfolio was roughly 30 percent. This means that China's euro-denominated holdings are now close to US$1 trillion. This is a very large sum that makes the euro 'too big to fail'. In other words, the survival of the euro has now become systemically important for Beijing.

Europe, China and the reform of the IMS

China's active diversification away from the dollar and into the euro at the peak of the eurozone sovereign debt crisis is important since at approximately the same time US money market funds were reducing substantially (by around US$300 billion) their exposure to eurozone banks.[6] With this massive withdrawal of funds from the eurozone, only China's offsetting purchases can explain the resilience of the value of the euro in the foreign exchange markets throughout the crisis (see Figure 2). This trend was recognised by no other than George Soros, the international investor, who was for some time shorting the euro.[7]

The question that follows is whether China's actions had any impact on the strategic partnership of the EU and China, and specifically on Sino-European collaboration in the reform of the IMS. French officials certainly sought to strengthen their ties with their Chinese counterparts in the run-up to and during the French presidency of the G-20. After some lobbying by the French government, in March 2011 Beijing agreed to hold a high-profile seminar on the reform of the IMS in Nanjing. Despite these efforts, though, this collaboration failed to deliver any substantial outcomes. The Nanjing seminar, for instance, did not yield any concrete progress in terms of redesigning the IMS. European policymakers might disagree with this assessment. They argue that a protectionist backlash in response to the crisis has been avoided, that the surveillance mechanism on global macroeconomic imbalances has been strengthened, that China has finally accepted that its currency value should be increasingly determined by market forces and that Sino-European collaboration has been vital in boosting the funds of the IMF. But overall, the reality is that these are only marginal advances. They do not address the structural asymmetries and inherent flaws of the current IMS.

5. James Anderlini and Tracy Alloway, 'Trades reveal China shift from dollar', *Financial Times*, 20 June 2011. See also: Tom Orlik and Bob Davis, 'Beijing Diversifies Away From U.S. Dollar', *Wall Street Journal*, 2 March 2012.

6. Mary Watkins, 'US money market funds cut euro exposure', *Financial Times*, 25 July 2012.

7. Gregory White, 'Soros: China Saved the Euro', *Reuters*, 15 September 2012.

Figure 2: Dollar-euro exchange rate (1999-August 2012)

Source: ECB

There are several reasons for the lack of fundamental progress. China doubts whether France is representative of the European position. Unofficially, French officials have never hidden their dismay regarding the corner options (free floating and fixed exchange rates) in the IMS. Intellectually, they have always been fond of more symmetric and stable exchange rate target zones or bands for the main international currencies. In this regard, they are closer to the mainstream view in China which is sceptical about the merits of fully flexible exchange rates.[8] However, officially France sides with the US, the UK and Germany in demanding that China let the value of its currency be decided by market forces. China has in principle signed up to this in the G-20 communiqué issued in Cannes in November 2011. But the wording was sufficiently vague to allow China to avoid sticking to its pledge.

Furthermore, Chinese officials are convinced that the US would be against any target zone arrangement, as unofficially proposed by the French. In their view, the US will keep exploiting its exorbitant privilege. It is also clear that the positions of France and Germany are different. While France would potentially welcome a more intervention-

8. Miguel Otero-Iglesias and Ming Zhang, 'EU-China Collaboration in the Reform of the International Monetary System: Much Ado About Nothing?', Working Paper no. 2012W07, Research Center for International Finance, Chinese Academy of Social Sciences, Beijing, April 2012.

ist framework, Germany would oppose any objective (including exchange rate bands) which might come into conflict with the sole mandate of the ECB of maintaining price stability. This position is also shared by the European Commission.

After realising that Europe sides with the US in the promotion of flexible exchange rates and free capital flows and that it is dragging its feet in handing over more IMF voting shares to the BRICS, China has decided to turn its attention away from the West. It has for example declined to be part of the G-7, where decisions on the exchange rate are taken. Beijing seems to believe that it would come under huge pressure from the US and the European countries to let its currency float. Instead, China has decided to go its own way. At the national level it has been promoting the Renminbi (RMB) as an international currency. For China a tripolar monetary system with the dollar, the euro and the RMB is the most likely future scenario (interestingly, European officials appear to agree with this assessment). On a regional scale, China has tried to further develop the Chiang Mai Initiative and at the BRICS level it has been promoting the creation of a joint development bank and a foreign reserve fund.

How to Improve collaboration with China

Today global economic governance in monetary affairs is at an impasse. Some scholars argue that we are increasingly in a G-Zero world where the US is incapable of leading, Europe is reluctant to push for substantial reforms and the BRICS countries are free-riding on a liberal system that provides them with great competitive advantages without taking on major responsibilities.[9] This is a problem for Europe because increasingly it has to deal with great superpowers that practise multilateralism *à la carte* and use their monetary statecraft, 'understood as efforts to influence the policies of other states by manipulating monetary conditions'[10] to deflect macroeconomic adjustment costs onto their trading partners. For over a decade the eurozone has been the only safety valve through which the pressures inherent in the IMS could be released. In some ways, the euro has been the victim of its own success. It has taken on most of the adjustment burden necessary to rebalance the US current account deficit. The loose monetary policy applied by the FED since the early 2000s pushed the dollar down and the euro up. The single currency experienced an appreciation of almost 100 percent from 2002 when it traded at US$0.86 until 2008 when it reached US$1.60 (see Figure 2). In an ideal world of fully flexible exchange rates some of the adjustment burden should have fallen onto the Chinese RMB but by pegging their currency to the dollar, the Chinese authorities protected their exporters. The current crisis in the eurozone periphery is partly a consequence of these developments. Countries such as Japan, Brazil and Switzerland have realised this and have started intervening in the foreign exchange market once they saw that they were suffering

9. Ian Bremmer and Nourriel Roubini, 'A G-Zero World', *Foreign Affairs*, vol. 90, no. 2, 2011, pp. 2-7.

10. C.Randall Henning, ´The Exchange Rate Weapon and Macroeconomic Conflict', in David M. Andrews (ed.), *International Monetary Power* (Ithaca: Cornell University Press, 2006), pp. 117-38.

the same adjustment process. We are thus faced with the spectre of what the Brazilian Minister of Finance Guido Mantega was the first to call 'currency wars'.

How could the EU revive its collaboration with China and halt the above developments? This is not an easy task, especially because China has become very suspicious of European proposals. To overcome this lack of trust, the EU needs to show that it understands Chinese concerns regarding the risks involved in having a fully convertible and free floating exchange rate and free capital flows. Chinese leaders need to feel that the Europeans understand their legitimate fears and accept that China will reform at its own pace and following its own objectives. Rigid dogmas need to be off the table, not least because the same worries that today haunt Chinese policymakers were commonplace in Europe in the 1970s and 1980s. Thus, siding with the US in its demand that China must have a free floating currency, free capital flows and an independent central bank in order for its currency to enter the IMF Special Drawing Rights (SDR) basket is counter-productive, especially because the Japanese yen did not fulfill these conditions when it entered the basket.

At the same time, EU officials could convey to their Chinese counterparts that their country is now systemically important, which implies that China has certain responsibilities with regard to the effects of its national macroeconomic policies and the reconfiguration of the IMS. Here again the Europeans need to break the circle of distrust. Beijing thinks that Europe and the US are holding back the reform process in the IMF in order to maintain their voting powers and influence. Europe needs to show that it is serious about reform because it is in its best interest to do so. The current *status quo* is certainly not the best scenario for Europe. Effective multilateralism needs to be restored. It would be even worse if the BRICS, led by China, were to start building parallel institutions due to the deadlock in global economic governance.

What next?

In the wake of the global financial crisis and the eurozone crisis China has become a key player in the reconfiguration of the IMS. It is by now clear that China has supported the European common currency in its moment of need. While Anglo-American investments funds were betting against the euro, China supported it. Of course this is not due to altruism. China has its own reasons to support the single currency. A united Europe is fundamental for the creation of a multipolar monetary system, and the euro is the main diversification alternative to the dollar. The European market is vital for Chinese exports and the main source of high-tech imports. In other words, the euro is 'too big to fail' for Beijing. Thus, its investments in European debt do not provide the political leverage that is sometimes suggested. Europe, however, should not discount China's help. It should use China's greater involvement in Europe to enhance bilateral relations and safeguard its own interests more effectively.

The following suggestions are offered:

With regard to China

1. Europe could open discussions with China exploring the feasibility of a compromise over China's macroeconomic policies with regard to its exchange rates, its capital account and the status of its central bank. This could open the door to China's entry to the G-7.
2. The EU could make the case more strongly that, at the current juncture, a weaker euro would benefit both China and the eurozone. The eurozone periphery would increase its competitiveness while China would be able to invest in Europe more cheaply. The EU could also use China's eagerness to invest in Europe at cheaper prices to negotiate an investment agreement with China.
3. Europe and China should strengthen their bilateral collaboration in managing the internationalisation processes of the euro and RMB and their regional monetary cooperation frameworks. Both sides are keen to see the emergence of a multipolar monetary system based on a more symmetric share of the 'exorbitant privilege'. In order to smoothly manage the transition from a dollar-dominated to a multipolar system more cooperation will certainly be needed.
4. A high-level Sino-European taskforce could be created to study different options with regard to the reform of the IMS. This taskforce could be open-minded on exchange rate and capital flow regimes. This group could present its joint report to the other G-20 countries. As the late Tommaso Padoa-Schioppa pointed out, finding solutions to the inherent flaws in the IMS should be one of the key tasks of the current generation of policymakers.

Within the EU/eurozone

5. The EU could establish a high-profile working group to study the option (and the possible effectiveness) of having a single seat for the eurozone at the IMF.
6. EU countries' treasuries could emulate the US Treasury and disclose the country origin of the main holders of their debt. This would enhance transparency with regard to China's support and avoid distrust and tensions between the EU member states.
7. EU and especially eurozone countries could consider in earnest the issuance of eurobonds or project bonds in considerable amounts as an effective debt instrument to attract funding at competitive interest rates. Chinese policymakers have on numerous occasions declared that they would be interested in such a safe and more liquid debt instrument.

Finally, the EU, or at least the eurozone, needs to develop a united economic diplomacy strategy towards China on macroeconomic policies, trade and investment. Monetary statecraft is difficult to forge because the EU/eurozone is not a state. However, it is important to develop this tool to tackle the current international economic environment and as a response to the tendency by other great powers to resort to this strategy.

THE VIEW FROM THE EU

Raul de Luzenberger[1]

Global economic cooperation and global economic governance are today core issues in EU-China relations and an important element of their future collaboration. Miguel Otero-Iglesias' paper is well-researched, full of valuable insights, practical suggestions and food for thought.

I like the paper's clear forward vision about the need for the euro area to act as a coherent bloc to promote its own interest. This is what our partners outside the EU consider normal and would like to see happening. In addition, I entirely subscribe to the author's view that the EU and China have a joint interest in deepening cooperation. The paper is informative and helpful, in particular for the insight it affords into the point of view and actions of the Chinese leadership and into China's increasing role as a global player and leading economic power with a clear policy towards the euro.

By way of a general response, I would like to make two points. First, in many official fora China likes to remind its interlocutors that it is not yet a fully advanced economy. The obvious implication is that sometimes we forget in our discussions that China still needs to enact important reforms and fully develop its economy and markets. Second: we often underestimate the extent to which the EU is also a model for other countries and the integration process. In Asia a number of regional initiatives are consciously modelled on the EU experience.

This gives the EU a unique opportunity to deepen cooperation with other countries and regional cooperation frameworks that can be instrumental in reinforcing economic and political linkages with the EU.

In my view, these considerations call for a medium-term approach to developing stronger cooperation. Recent years have seen the establishment of very good working relations between the EU's and China's economic teams. On the Chinese side this involves the Ministry of Finance (MoF), the National Development and Reform Commission (NDRC) and the People's Bank of China (PBoC), but also the Chinese Sovereign Wealth Fund (China Investment Corporation) as well as the agency managing China's currency reserves (State Administration of Foreign Exchange – SAFE). Regular macroeconomic and financial dialogues have taken place between relevant Commission services (DG ECFIN, MARKT), the ECB and their Chinese counterparts (the Ministry of Finance, National Development and Re-

1. Deputy Head of Unit, Unit D3 – Countries of the G20, IMF, G-groups, at DG ECFIN in the European Commission. The views and opinions expressed in this article are those of the author and do not in any way represent the official view of the European Union and of the European Commission.

form Commission and the People's Bank of China). Contacts have developed into a very extensive network of bilateral meetings, taking place in addition to meetings in multilateral frameworks (G-20, ASEM). The EU has also dedicated time and resources to explain to the Chinese the international role of the euro and its status as a global currency.

China is a key player in the G-20 and a very important partner for the EU in discussions on global governance and IMF reform. While in general siding with the other BRICS, China has often taken a more constructive attitude. For example, in summer 2012 China provided US$43 billion, roughly 10 percent of the total amount, to the strengthening of IMF resources.

In the G-20 framework, alongside other advanced economies and also some emerging market economies (EMEs), the EU continues to press China to do more in terms of global rebalancing and the rotation of global demand, insisting that China moves towards a more flexible exchange rate regime. In my view the logic behind this is twofold. On the one hand, reducing China's trade imbalance and narrowing global imbalances limits potential risks for the global economy. On the other hand, supporting the growth of public/private consumption inside the country helps China in taking the difficult decisions and implementing the deep structural reforms necessary for its transition to a more sustainable and balanced growth model. This, I believe, is very much in the interest of China as the country needs to reduce its dependency on investment and exports by changing its growth model permanently.

I believe that the EU should seize the opportunity presented by the appointment of a new leadership to revitalise meetings at top level with the so-called euro area troika. Establishing good early contacts at the highest level with the new Chinese leadership will move the EU-China bilateral agenda forward in a way similar to what took place up until 2010 with the visits of the euro area troika to China and the High-Level Experts Discussions. On both sides there are important global and bilateral topics to be developed, and in relation to which successful EU-China cooperation could prove to have very positive repercussions.

In the monetary field, the euro area could enhance its support for the internationalisation of the RMB. This could also help promote the necessary internal reforms in China and favour the use of EU financial markets by Chinese companies and banks who intend to benefit from European expertise and its infrastructure (after Hong Kong the major financial centres for RMB transactions are currently Paris and London). This is clearly an area which provides for a clear win-win outcome to joint efforts. In a similar way, the various efforts at regional economic and trade cooperation in East Asia, e.g., the Chiang Mai Initiative Multilateralisation (CMIM), the creation of FTA areas in ASEAN + 6 etc., provide another clear opportunity. While it is still early days to speak about a significant movement towards regional economic integration, the EU can gain an additional avenue to strengthen its presence and outreach in the region by supporting these efforts.

To conclude, I believe that the EU and China have important common interests on global economic and governance issues on which to develop solid cooperation and understanding over the medium term.

IV. ENVIRONMENT AND RESOURCES

THE EU'S CHINA POLICY ON ENVIRONMENT AND RESOURCES

Bernice Lee

Introduction

In September 2012, on the occasion of the 15th EU-China Summit, the European Union (EU) and China agreed to 'join forces to address environment, urbanisation and climate change challenges'. These announcements of joint initiatives are reminders that notwithstanding the ebbs and flows in EU-China relations, the rationale for collaboration on the environment and resources remains compelling.[1]

China and the EU together account for around 32 percent of global energy consumption and 35 percent of global CO_2 emissions.[2] The International Energy Agency (IEA) estimates that both will be importing the bulk of their oil needs by 2030. Ensuring security of supply – and political stability in the world's resource-rich regions – is thus important to both. The two sides also had similar and ambitious policies to improve security of supply through greater efficiency and the increased use of renewable energy. Both need to manage climate-related impacts ranging from water stress to shifting agricultural zones to extreme weather. With the looming investment needs in the power sector, the two regions need to make urgent decisions to avoid locking in carbon-intensive investments in the coming decades.

Despite the rationale for joint EU-China collaboration on environment and natural resource management in areas like forestry and biodiversity, some of the fundamental conditions for this collaboration have shifted over the past decade. This paper will explore the state of the EU's China policy on the environment and resource security, including outstanding challenges, as well as outline options for improving the effectiveness of EU policy towards China on environment and resources.

1. Bernice Lee, Antony Froggatt, Nick Mabey et al, *Changing Climates: Interdependencies on Energy and Climate Security for Europe and China*, Chatham House Report (with E3G), 2007.

2. International Energy Agency (IEA), *World Energy Outlook 2012*, 2012.

The nature of EU engagement

EU-China cooperation on the environment and natural resources is not new. Discussions on clean energy cooperation, for example, began in 1994. The relationship was elevated to a vice-ministerial level environmental dialogue, together with the launch of a co-financed Energy and Environment Programme in 2003. Over the past ten years, most attention has been paid to cooperation on climate change. This is a reflection of the growing significance of this agenda for the EU. A bilateral Partnership on Climate Change was launched at the 2005 EU-China Summit, emphasising cooperation on concrete action, such as the progress and deployment of clean energy technology. The dialogue was upgraded to minister-level talks in 2010.

The mainstay of EU cooperative activities with China on the environment is practical and technical in nature, backed by substantial financial contributions from the EU (see Table 1). Science and technology cooperation has been a consistent focus, whether on cleaner coal or efficiency, alongside clean energy finance. These types of activities – with the emphasis on technical and practical cooperation – have been described by Elizabeth Economy as 'techno-diplomacy', a track most favoured by scientific and environmental elites in China.[3]

These high-level initiatives have contributed to keeping alive the agenda and debate on China's environmental management record as well as the centrality of the transition to a lower carbon economy. They have also spurred many technical undertakings, ranging from low-carbon city and transport planning, clean energy development, collaboration on the Zero Emissions Platform to sustainable urbanisation. Project grants covering a wide range of issues from EU member states and the Commission amounted to some €292 million by 2008.[4]

3. Elizabeth Economy, 'China's Environmental Diplomacy', in Samuel Kim (ed.), *China and the World: Chinese Foreign Policy Faces the New Millennium*, (Boulder, CO: Westview Press, 1998).

4. Data from the European Commission, accessed and analysed by Chatham House in 2008. The data is almost certainly an underestimate since these are projects officially recorded as cooperation projects – and a significant number of projects are not listed in this way. The vast majority of the projects represented in the data took place in the last five years.

Table 1: Funding for major EU-China programmes since the Partnership on Climate Change

Major projects	Budget (million €)
Energy and Environment Programme	45
EU-China CDM Facilitation Project: 2007-2010	3
EU-China Environmental Governance Programme: 2008-2010	15
EU-China Clean Energy Centre (EC2)	10
Euro-Chinese Institute for Clean and Renewable Energy (ICARE)	10
FP-6 and FP-7 relevant joint research projects	12
Construction of near zero emission coal-fired power plant	50
Sustainable and Responsible Trade promotion through Forest and Trade Networks	2
Supporting policy, legal and institutional frameworks for the reform of forest tenure	2
Biodiversity Protection Programme	30
EU-China River Basin Management Programme	25
Natural Forest Management Project	15.5
Emission Trading System	5
Sustainable Urbanisation	9.5
Water, waste and heavy pollution	9
Electric Motor Systems Energy-Saving Challenge – Improving the Operating Efficiency of Chinese Electric Motor Systems	1
Implementing industrial symbiosis and environmental management systems in Tianjin Binhai area	1.5
Improving Environmental and Safety Performance in Electrical and Electronics industry in China	2
Sustainable Public Procurement in Urban Administrations in China (SuPP-Urb China)	0.5
Sustainable revival of livelihoods in post-disaster Sichuan: Enhancing eco-friendly pro-poor bamboo production supply chains to support the reconstruction effort	2
China Higher Efficiency Power and Distribution Transformers Promotion Project	0.5

Source: Duncan Freeman and Jonathan Holslag, 'Climate change, China and the EU: Different Policies, Same End?' BICCS *Asia Paper*, vol. 4, no.5, 2009, with data from the European Commission

Achievements and challenges

On the positive side, there is ample evidence of policy learning transfers from the EU to China, from eco-labelling standards to support for renewable energy. Table 2 illustrates the shortened lag time between China and the EU in key policy areas such as vehicle emissions standards. Another example is the transfer of expertise on market mechanisms from the EU to China.

Table 2: Timeline of European vehicle emissions standards and Chinese equivalent

Euro Standard	EU	China	Beijing
1	1993	2000	2000
2	1997	2004	2002
3	2001	2007	2005
4	2006	2010	2008
5	2011		2012
6	2015		

Source: Compiled by Felix Preston, based on table in Felix Preston, Antony Froggatt and Bernice Lee, 'Chongqing's global future: Towards a low-carbon economy', Programme Paper, Chatham House, June 2009.

Purchasing carbon credits from China's Clean Development Mechanism (CDM) projects became an important way to help EU-15 member states to accomplish Kyoto compliance and private companies to meet EU-Emissions Trading System (ETS) targets. This joint EU-China CDM work, in turn, helped confirm to Chinese businesses and stakeholders that climate-related, environmentally sound investments could be commercially attractive. It also helped diffuse the concept of carbon trading in China, contributing to the pilot emissions trading projects currently being undertaken in seven provinces and cities in China.[5]

Last but certainly not least, support from the EU and member states (together with foundations and other donor governments) has also helped raise the profile of environment-related government agencies and ministries within the Chinese hierarchy, through activities undertaken by the China Council on International Cooperation on Environment and Development (CCICED), for example.

Notwithstanding the proliferation of bilateral activities, prevailing concerns over trade and competitiveness – whether over China's export restrictions, subsidies, local content requirement, intellectual property or the uneven playing field for foreign

5. For a recent analysis on the status of emissions trading pilots in China, see Guoyi Han, Marie Olsson, Karl Hallding and David Lunsford, *China's Carbon Emission Trading: An Overview of Current Development* (Stockholm: FORES, 2012).

companies in China, especially in the services sector – continue to dominate broader EU-China relations. Trade-related concerns also cast a shadow over the prospect of deepened environmental cooperation, ranging from disputes on solar panels, China's monopoly of rare earth minerals to Chinese subsidies on high-tech exports, in addition to the iconic anti-dumping dispute on energy-efficient light bulbs in 2007,[6] to name but a few. Of the 37 ongoing EU trade defence investigations from June 2011, 15 (40 percent) involve Chinese companies.[7]

Additionally, austerity and competitiveness fears, together with more traditional concerns like human rights, have cemented the downward trend in European public opinion regarding China from the peak in the mid-2000s. As economic conditions have worsened in the EU in the past five years, EU member states have found it far more difficult to justify investments or cooperation that could strengthen the economic competitiveness of emerging economies like China who, in the eyes of the European public, have failed to step up to meet the global environmental challenges, particularly that of climate change.[8]

In 2011 a plan was proposed by the European Commission to stop bilateral aid to emerging economies, including China, by 2014.[9] While the willingness of developing countries to step up national-level action and environment-related efforts clearly depends on international assistance provided by rich countries, it is an argument increasingly difficult to sell to constituencies in industrialised economies at a time of fiscal austerity and growing economic competition from emerging economies.[10]

China's behaviour in global climate negotiations also failed to win new favours among the European environmental community, who were among the most vociferous supporters of China-related engagement in the mid-2000s. At the core of the misgivings is the fact that blossoming technical cooperation and financial support for China's environment-related work did not necessarily translate into meaning-

6. In 2007, China and the EU quibbled over long-standing anti-dumping duties on energy-efficient compact fluorescent lamps from China. In reality, on one side of the fight was Osram, an arm of Germany's Siemens, who pushed for the duties to be extended citing risks to EU jobs. On the other was Philips, a Dutch manufacturer, who together with other manufacturers wanted the duties lifted, as most of their energy-efficient bulbs were produced outside of the EU, including in China. See, for example, AFP, *EU greenlights anti-dumping duties on Chinese light bulbs*, 17 October 2007; Stephen Castle, 'Europe to keep tariffs on light bulbs', *New York Times*, 29 August 2007; Patrick Messerlin and Jinghui Wang, *Redesigning the European Union's trade policy strategy towards China*, Joint ECIPE-GEM Working Paper no. 4, 2008, p. 10.

7. Data from European Commission, Trade Defence: Investigations, 2012. Available at: http://trade.ec.europa.eu/tdi/index.cfm?sta=21&en=38&page=2&c_order=date&c_order_dir=Down.

8. Alexander Neubacher, 'A Capital Error? Germany Created Own Threat with Chinese Solar Aid', *Der Spiegel* Online, 27 February 2012; 'The Sun Goes Down on Solar', *Der Spiegel*, 4 April 2012.

9. See Stanley Pignal, 'EU to stop aid to fast-growing countries', *The Financial Times*, 7 December 2011 and European Commission, *Press release: The Multiannual Financial Framework: The Proposals on External Action Instruments*, MEMO/11/878, 2011. Available at: http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/878&format=HTML&aged=0&language=EN&guiLanguage=fr.

10. Robert Falkner and Bernice Lee, 'Introduction', *International Affairs Special Issue on Rio+20 and the Global Environment: Reflections on Theory and Practice*, vol. 88, no. 3, 2012, pp. 457-62.

ful joint leadership in the international sphere or credible political capital for the EU in other policy areas.

As was evident from the Copenhagen fallout in 2009, China and the EU have remained far apart during many of the formal climate negotiation processes despite these joint initiatives. For many observers, the public display of hostility during the Copenhagen Conference testified to the failure of bilateral engagement in changing China's position. But it also raised the question of how best to assess any external influence on China's decision-making and policy action.

China's dogged defence of the sovereignty doctrine would in any case prevent any public acknowledgment of external influence on its domestic agenda, which makes it extremely difficult to assess the extent of EU influence on China. But assumptions of a monolithic China that always acts rationally can be misleading, as China's consensual decision-making system has to balance a wide range of domestic, sometimes conflicted, vested interests.

What next?

In recent years, issues related to access to critical resources like metals and energy have become a lightning rod in China's external relations. Capturing most global attention are the production of rare earths – and the metals and magnets that derive from them – which is overwhelmingly dominated by China. According to 2010 figures, China produces 97 percent of the world's rare earth supply and 79 percent of the rare earth magnets. Today, access to rare earth metals is already creating trade tensions between China, the United States and the EU. Western countries are accusing Beijing of using its complex export quota system to unfairly restrict access for Western companies, in order to strengthen China's position in the valuable downstream processing industries.

These trade- and resources-related disputes will likely result in more public spats in the coming years, not least due to the perception of impending resource crunches and fears about China's rise. Within the EU, more questions will be asked by member states and stakeholders on the effectiveness of environment- and resources-related technical cooperation in China. Moving forward, a re-thinking of means and strategies needed to influence China is required on environment and resources-related issues.

First, EU businesses will be pushing for activities with more direct benefits to the EU rather than those that are seen to strengthen the competitiveness of Chinese industries regardless of the environmental integrity of these interventions. This will be a minefield for the EU and the member states to tread, but more attention could be paid to pre-competitive technology-related cooperation, for example on the circular economy.

Second, it remains questionable whether the EU's China engagement will result in imminent joint global environmental leadership. It is therefore critical to set realistic goals and expectations. For example, if the goal is to ensure that China will continue to step up its efforts towards environmental sustainability, it is equally important for the EU to engage with China's competitors – whether India, Indonesia or South Korea – to help raise the global standard for environmental protection.

Third, more engagement is needed on issues related to the 'long tail' of China's investments abroad and their environmental legacy. These could be topics of discussion for the non-China strategic partnerships undertaken by the EU.

Last but not least, it would be critical to deepen technical cooperation on priority issues with China with regard to the environment, even though more attention is needed to reflect the respective and evolving roles of the two parties as China gains experience in environment and resource management.

For example, China uses coal to generate around 80 percent of its energy needs, and it is likely to increase in China in the foreseeable future. The EU is also struggling to phase out coal in its power sector. Europe and China could upgrade their existing cooperative programme to reduce coal-related emissions though the development of carbon capture and storage technology, with a view to having a full-scale demonstration plant in operation by 2015.

In April 2012, the EU launched a new initiative with China on sustainable urbanisation. This is a step in the right direction. The new housing that will be built in China between 2010 and 2020 is equal to all the existing housing stock in the EU-15; and the EU housing and building sectors together are the largest CO_2 emitter. Acting together now to improve efficiency standards would help avoid locking in inefficient housing with high CO_2 emissions for the next half-century. This also applies to the transport sector.

Since China manufactures a vast array of goods for Europe and much of the world, adopting world-class standards for energy-efficient goods would bring clear global benefits. Under the Eco-Design Directive, the EU has been setting increasingly tight energy efficiency standards, and China and the EU could drive progress in both their markets by working together in defining challenging standards for energy-efficient, low-carbon goods. This could be coupled with the introduction of an EU-China ultra-efficiency building research platform to drive new technical and development opportunities in this fast-growing sector.

While China has captured much of the low-hanging fruit in the past two decades in the environmental sphere, the next five years represent a critical testing time for the viability of lower carbon, greener growth across China. This will entail further waves of regulatory actions and structural interventions – whether in terms of pricing environmental externalities, investing in the next generation of infrastructure or upgrading industries. The EU is in a unique position to offer world-class lessons and learning, but this will not be straightforward even under better economic circumstances.

THE VIEW FROM THE EU

Magnus Gislev[1]

There is indeed a compelling rationale for the EU and China to engage with each other in the area of the environment and natural resources. The Chinese economy is huge but the country also faces enormous environmental challenges of both a local (e.g. heavy metals pollution) and global (e.g. carbon dioxide emissions) nature. EU engagement with China is critical for meeting the EU Treaty objectives in Europe as well as in the world as a whole.

Why is China trying to go green?

The Chinese government has in recent years, especially during the second half of the 11th Five-Year Plan and the beginning of the 12th Plan, undertaken a host of initiatives on the environment including regulatory, market-based and information instruments. Why this fresh interest in the environment? What are the drivers?

Firstly, they are increasingly realising that the current development pattern is not good for the economy. Every year the damage caused to the environment and the erosion of China's natural resource base corresponds to several percent of the Gross Domestic Product (GDP). Secondly, China's fast-growing middle-class is making more and more vocal demands for decent environmental standards. The government considers it necessary to respond to these demands (as when they extended some air quality measures that were originally intended as temporary ones during the 2008 Beijing Olympics). Thirdly, the government is aware that there are certain irrefutable global responsibilities, especially as China is now by far the biggest global emitter of carbon dioxide. Last but not least, they have realised that there are tremendous business opportunities in the green technology sector.

The world stage: a role for China similar to that of the EU?

As Bernice Lee has noted, it is however highly questionable whether China is ready for 'global leadership' on these issues, let alone ready for any joint global leadership with the EU. At least if by 'global leadership' we mean playing the role of responsible stakeholder and pushing for ambitious and legally binding multilateral agreements. Up until the 2011 climate change conference in Durban, China advocated a very rigid interpretation of the principle of common but differentiated responsibilities, divid-

1. Policy Officer at the European Commission. The views and opinions expressed in this article are those of the author and do not in any way represent the official view of the European Union and the European Commission.

ing the world into just two groups of developed and developing countries entailing completely distinct obligations for each group. Realising that this interpretation was no longer tenable, China agreed in Durban to a compromise whereby as of 2020 there should be commitments with legal force for all countries to control greenhouse gas emissions.

Another example of Chinese reticence towards multilateral environmental deals concerns mercury, a highly toxic heavy metal that accumulates in the food chain. At the beginning of 2009, the EU had for years been pushing strongly for the opening of international negotiations to reduce levels of mercury in the environment, while the US and China had been the main sceptics with regard to this initiative. When President Obama took office the US changed its position and subsequently so did China.

A third example is the 'Rio+20' UN conference on sustainable development held in June 2012 which had 'the green economy' as a major theme. While China has made the green economy – alongside the circular economy and low-carbon economy – an official objective in its national policy, the Chinese did not want the Rio conference to result in any internationally binding obligations to promote a transition to a green economy. In stark contrast to the EU, the Chinese delegation went to Rio without really putting any new ideas on the negotiating table for collective responses to the huge sustainable development challenges that the world is facing.

However, the examples from the international climate and mercury negotiations show that the Chinese government is keen to avoid being seen as 'the bad guy' and is therefore ready to compromise when the only other option is isolation.

Mutual trust – a winning recipe?

Given that China is progressing very slowly in assuming greater responsibility for global environmental governance, what can the EU do to encourage China to take bigger steps? It is clear that we need to build more mutual trust by further strengthening our bilateral cooperation. I can only agree with Bernice Lee that there is strong interest on the Chinese side in what has been referred to as 'techno-diplomacy'. Our diplomatic efforts must go beyond just talking to each other. We need to continue sharing concrete and practical experience of how we are dealing with various environmental and sustainable development challenges. When this is done in an objective, scientifically sound and non-politicised manner, there is often strong interest among Chinese policymakers. In fact, at the latest EU-China high-level environmental dialogue, Environment Minister Zhou referred to the EU as China's 'most important partner' in environmental affairs. I would also agree with Bernice Lee's assessment that the EU has helped to raise the profile of the Chinese environmental and climate change ministries and departments within the Chinese government hierarchy.

Even so, there are of course a number of stumbling blocks in EU-China relations regarding the environment and natural resources. Some of these are indeed closely linked to trade issues and concerns over competitiveness, such as the much debated opening of an investigation by the European Commission into possible price dumping by Chinese producers of solar panels, an investigation with major stakes in terms of market value, competitiveness and the transition to a low-carbon economy.

Competition for limited natural resources is another potential source of friction. In 2011, the European Commission identified the 14 most critical resources to EU industry. For nine out of these, China was among the top three producers globally, which highlights the importance of China as a supplier of critical resources. The EU's main approach to dealing with this challenge is to monitor developments and to solve issues that may arise through dialogue with the countries concerned. If there is evidence that international rules have been violated and cannot be resolved through dialogue, there is always the possibility to resort to the dispute settlement mechanism of the WTO.

What next?

Regarding Bernice Lee's proposals for future EU engagement with China on environment and natural resources, it would seem appropriate to do the following:

- Continue to exploit the EU's 'unique position' in environment policy development and implementation as far as possible taking into account that the EU as of 2014 will have fewer financial resources for cooperation with China (due to the fact that China will no longer receive bilateral development assistance from the EU).
- Expand our practical cooperation with a greater emphasis on integrating environmental and sustainability issues into multi-sectoral initiatives such as under the recently established EU-China Water Platform and EU-China Urbanisation Partnership.
- Strengthen business-to-business cooperation (in energy, water and other key sectors) as far as possible taking into account the continued concerns of European industry as regards China's ability to enforce the rules on protection of intellectual property.
- Foster pre-competitive research and development cooperation including in housing, transport and low-carbon goods.
- Seek to gradually address the environmental and resource impacts of Chinese investments abroad, which has started as part of our dialogue on forest law enforcement and governance.

This all amounts to an ambitious agenda that should both be in line with the interests of China and supportive of the EU's ambition to promote smart, sustainable and inclusive growth in the European Union and beyond the EU's borders.

V. DEFENCE AND SECURITY

EU SECURITY POLICY TOWARDS CHINA

Frans-Paul van der Putten

The security dimension in EU-China relations

Within EU-China relations, the economic dimension traditionally dominates. This chapter discusses the EU's security policy with regard to China, and how this may be developed further. After the end of the Cold War, defence and military-related issues gained prominence only during 2003-2005, when the EU member states debated a possible end to the EU arms embargo against China and when technological cooperation intensified. However, recently the EU has taken steps to strengthen its security policy on Asia and China. In June 2012 the EU published the guidelines to its foreign and security policy in East Asia. Moreover, in July the EU foreign policy chief Catherine Ashton for the first time attended the annual ASEAN Regional Forum (ARF). At the ARF she met the US Secretary of State Hillary Rodham Clinton to issue a joint EU-US statement on security and other issues in the Asia-Pacific region.

In the document outlining the EU's security policy guidelines for East Asia, several elements relate to the security, defence and military aspects of EU-China relations. These include the following policy aims for the EU:[1]

- develop the High-Level Strategic Dialogue with China
- encourage more military-to-military exchanges among Asian countries such as China and the EU member states
- promote human rights and democracy in China
- encourage China to be more transparent on military affairs, to take up more international responsibilities and to support the build-up of effective multilateralism
- cooperate with China on global security issues such as non-proliferation, counter-terrorism, counter-piracy, conflict prevention, and peacekeeping
- engage with China on its activities in the developing world, in particular Africa
- promote good relations between China and the US, and between China and Japan
- encourage 'parties concerned' (such as China) to solve disputes in the South China Sea in accordance with UNCLOS and to clarify the basis for their claims
- Support ASEAN integration and regional forums such as the East Asia Summit (EAS)

1. General Secretariat of the European Union, 'Guidelines on the EU's Foreign and Security Policy in East Asia', Brussels, 15 June 2012.

- strengthen the EU's partnership with the US, develop its strategic dialogue with the US, and support the US security presence in East Asia
- develop political dialogue with extra-regional partners such as Russia, Australia and India.

Based on this, the main aims of the EU's security policy relating to China may be summarised as: (i) to strengthen security interaction with China in terms of military-to-military exchanges, strategic dialogue, global security issues, and stability in Asia, Africa, and other developing regions; (ii) to stimulate China to liberalise its political system and to adjust its policies on military transparency and the South China Sea; (iii) to support regional security mechanisms in East Asia. All of these aims are to be approached both directly, through bilateral interaction with China, and indirectly, through political dialogues and coordination with third parties, in particular the United States.

The EU has a number of tools and potential tools at its disposal to work towards these aims. These include existing dialogues with China; the military-to-military exchanges that take place between EU member states and China; operational contacts between the EU's Operation *Atalanta* and the Chinese Navy relating to anti-piracy efforts in the Gulf of Aden; the EU's role as a major economic and technological power; the arms embargo against China; the close diplomatic and security ties between the EU's member states and the United States; existing dialogues with third parties; and the EU's membership of the ARF.

While the EU's approach to security, defence and military issues in its relationship with China is becoming more active and visible, it is clear that there are major outstanding challenges. Probably the most discussed among these relates to the arms embargo against China. Recently the Chinese government raised the profile of this issue. At the September 2012 EU-China summit, Chinese Premier Wen Jiabao urged the EU to end the embargo.[2] However, the failed attempt by various EU member states to end the embargo in 2005 made clear how sensitive the matter is, both in terms of domestic politics within Europe and with regard to EU-US relations.

Another challenge for the EU is to decide how it should respond to the recent request from Washington to cooperate more closely in East Asian security.[3] Most EU member states are NATO allies, but at the same time the economic significance of China has been increasing. Closer alignment with US strategic initiatives relating to China could draw the EU into regional conflicts in East Asia and complicate EU-China relations. It could also compromise the EU's ability to act as a more or less neutral player in Asia-Pacific affairs.[4]

2. See 'Chinese Premier Wen Jiabao urges end to EU arms embargo', *BBC News*, 20 September 2012. Available at: http://www.bbc.co.uk/news/world-asia-19657940.

3. Judy Dempsey, 'Transatlantic Cooperation on Asia', Carnegie Endowment for International Peace, Washington, 28 May 2012.

4. Nicola Casarini, 'EU Foreign Policy in the Asia Pacific: Striking the right balance between the US, China and ASEAN', Analysis, EUISS, Paris, September 2012.

An important third challenge is for the EU to contribute to regional stability in East Asia and to induce China to adjust its policies in various political and security domains with the limited means that are available to the EU and its member states. The European Union is not a significant security actor in East Asia. At the same time, China itself is an increasingly influential global actor that has demonstrated its ability to withstand foreign pressure to significantly change its political system or its defence policies.

Strengthening the EU Security Strategy with regard to China

The EU strategy on China must be seen in the context of its overall security aims. According to the 2003 EU security strategy document, 'A Secure Europe in a Better World', the European Union has three strategic objectives:[5] addressing threats (such as terrorism, proliferation, conflict areas, state failure, organised crime); building a secure neighbourhood; and contributing to an international order based on effective multilateralism. Of these, the latter seems to relate most directly to EU-China relations: China has become a major actor in the international system. However, China is also increasingly relevant to the former two strategic objectives. It is also important to take into account that for the EU and its member states, the United States is the primary partner for addressing each of these objectives. Consequently, the European security strategy relating to China should not endanger the basis for transatlantic security cooperation.

Moreover, the EU's security aims relating to China should correspond to its overall interests with regard to that country. Given the importance of economic issues in EU-China relations and the absence of military threat perceptions on either side,[6] promoting European economic interests is the foremost priority in the EU's China policy. In particular, the EU strives towards greater market access in China and equal competitive opportunities between Chinese and European businesses. A secondary interest relates to China's role in regional stability in East Asia, global economic and security governance, climate change, and international norms. China is a major counterpart for the EU's efforts to create a stable international environment that is conducive to international trade and investment, and that limits the emergence of threats to European security.

The aims of the EU's security strategy regarding China as derived from the June 2012 EU paper do not provide a clear-cut focus for EU policymaking. It is not apparent how the three main aims (engaging China, influencing Chinese policies, contributing to East Asian security mechanisms) interrelate, or how they support the primary overall aim of strengthening Europe's economic interests.

5. European Council, 'A Secure Europe in a Better World: European Security Strategy', Brussels, 12 December 2003; see also European Council, 'Report on the Implementation of the European Security Strategy: Providing security in a changing world', Brussels, 11 December 2008.

6. Frans-Paul van der Putten and Chu Shulong, 'Conclusion', in *China, Europe and International Security: Interests, Roles and Prospects* (Abingdon: Routledge, 2011), pp.195-96.

A European security strategy relating to China that would take into account most of the above-mentioned elements would be directed towards improving stability in the Asia-Pacific, including both China's relations with its neighbours and the Sino-US relationship. Regional stability directly affects the EU's economic interests. More-over, stable Sino-US relations are essential for the effective functioning of global governance institutions, and provide the best protection against a potential military conflict between the United States and China. Aiming the EU's security policies explicitly at Asia-Pacific stability would also make Europe more visible and relevant for this strategically important part of the world, and for both China and the US.

It is both necessary and feasible to do this. Although a major military clash between China and another country does not seem likely in the near future, tensions in East Asia are on the rise. In particular China and the US seem to be on a collision course. Experts such as Henry Kissinger and Hugh White have warned against the danger of Sino-US conflict.[7] The United States is strongly committed to the aim of preserving its global leadership,[8] by strengthening its influence in East Asia and maintaining leverage over China's international behaviour. At the same time, China's economic and military influence in East Asia is growing. If China becomes significantly more influential than it is today, which White and Kissinger believe to be very probable, then the region can only be stabilised if China and the US work out some form of joint leadership.[9] Indeed, in the long run East Asia can probably only be stable once there exists what Kissinger calls a Pacific Community. In such a configuration, the US would need to recognise China as its equal, while China would need to accept the US as a permanent 'resident power' in East Asia. It is in the interest of China, the US, and all other international actors – including the EU – that such a Pacific Community will indeed be established. The alternative would be long-term regional and global instability, or worse.

Although the EU and its member states are not military powers in the Asia-Pacific, the European Union is not without means when it comes to supporting regional stability. The most likely institutional basis for a future Pacific Community is provided by the ASEAN-related conglomerate of regional security platforms: the ASEAN Regional Forum (ARF), the ASEAN Defence Ministers' Meeting Plus (ADMM+), and the East Asia Summit (EAS). The EU is a member of the ARF, and could potentially play a role also in the EAS and ADMM+. Moreover, the EU has close relations with ASEAN. The two regional organisations are natural counterparts. ARF membership and close diplomatic ties with ASEAN enable the EU to make itself seen and heard when it makes statements on regional stability.

7. Hugh White, 'Obama and Australia's Vision of Asia's Future', *East Asia Forum*, 16 November 2011, available at: http://www.eastasiaforum.org/2011/11/16/obama-and-australias-vision-of-asias-future; Henry Kissinger, *On China* (New York: The Penguin Press, 2011), p.530.

8. Hillary Clinton, 'America's Pacific Century', *Foreign Policy* , November 2011. Available at: http://www.foreignpolicy.com/articles/2011/10/11/americas_pacific_century?page=full.

9. Hugh White, 'Building a Concert of Asia', *The Jakarta Post*, 19 August 2011. Available at: http://www.thejakartapost.com/news/2011/08/19/insight-building-a-concert-asia.html. See also Hugh White, 'China's Choices and Ours', *East Asia Forum*, 7 May 2012. Available at: http://www.eastasiaforum.org/2012/05/07/chinas-choices-and-ours/; Henry Kissinger, *On China* (New York: The Penguin Press, 2011).

Regarding Sino-US security relations, it is important to note that the European nations constitute Washington's foremost diplomatic and military partners. With a US security strategy that is increasingly dependent on the contributions of partners and allies, it is inevitable that Europe continues to play a major role in Washington's approach to China. While the US security engagement in East Asia is built on support from key regional allies such as Japan, South Korea, and Australia, the less visible role played by Europe is equally crucial. The United States can only rebalance (pivot) its security focus to Asia if key security tasks in other regions are picked up by its European partners. And for maintaining leverage over China in security affairs outside of East Asia, Europe's diplomatic support is again essential to the US strategy. This role makes it necessary for both the US and China to take into account the position of the EU and its member states when considering their security approach towards one another. This gives weight to EU dialogues on East Asian security affairs with both the US and China.

Finally, the fact that Europe does not play a direct role in the East Asian security hotspots enables the EU to take up a position of relative neutrality. Thus, while the US, China and all other regional countries have a major stake in regional stability, they have to balance this against their immediate national security concerns. The territorial disputes in the South China Sea provide a good example. ASEAN unity is a key precondition for regional stability,[10] but there are growing signs that Sino-US tensions in combination with the South China Sea disputes are undermining this unity. In 2012, the situation in the South China Sea prevented the ASEAN Ministerial Meeting for the first time from adopting a joint communiqué. The EU's interest in ASEAN unity is not compromised by national security issues and therefore the EU is in a position to put forward principles and norms that strengthen the unity within ASEAN. Moreover, any potential criticism by the EU regarding China's behaviour towards its neighbours and towards regional security will be more effective if this is voiced from a position of neutrality.

What next?

At this point, the European Union has three main options with regard to the security dimension of its China strategy. The first is to continue its long-standing approach of emphasising economic relations while keeping a low profile in security affairs. This approach is becoming less attractive, as pressure from Washington on the EU to be more visible in East Asian security affairs is growing, Europe's economic dependence on China grows, and the significance of East Asian stability and Sino-US relations for Europe is increasing. The second option is to closely follow the US strategy, and thus support Washington's policy of increasing pressure on Beijing. The problem in this regard is that it is not in Europe's interests to support the perpetuation of US

10. Fenna Egberink and Frans-Paul van der Putten, 'ASEAN, China's Rise and Geopolitical Stability in Asia', Clingendael Paper, Clingendael, The Hague, April 2011.

global leadership at all costs, if this involves the danger of long-term global instability, the paralysis of global governance, and possibly even a Sino-US war.

The third option is the one proposed by this chapter. The strategic aim of contributing to East Asian stability and stable US-China relations provides a concrete long-term objective, namely the building, with active European support, of a Pacific Community. It would provide a framework for the various policies and aims that exist in the current approach to security, defence and military affairs in EU-China relations. Although this is not a matter that can be addressed exclusively or largely from within Sino-EU bilateral relations, China is obviously a key actor on which to focus. Such a strategy would indirectly support the EU's interests in China's and East Asian economic affairs, by contributing to stability and by making the EU more visible as a political actor in the region.

The following suggestions are offered:

- The EU could produce a policy guideline for EU strategy regarding China based on the current 'Guidelines on the EU's Foreign and Security Policy in East Asia' by making explicit its main strategic aims relating to China, and by explaining how these aims interrelate and how they are to be prioritised. The EU could take into account, as basic principles, that its main interest relating to China lies in the economic sphere, and that its main security partner is the United States. The EU could use this strategic policy guideline to develop an active and autonomous security approach towards China. Maintaining a close security partnership with the United States should not preclude the development of such an approach.
- The main overall aim of the EU security strategy with regard to China should be to contribute to stable Sino-US relations at the global level and to regional stability in East Asia. This would be the most effective way to further the EU's economic and security interests, as it would maximise EU visibility and influence with the key security actors and in a strategically vital region, address the risk of having to choose sides between two rivalling powers, and limit the danger of paralysis in the global governance system.
- The EU should therefore focus its approach firmly on strengthening ASEAN unity and regional stability, by formulating, announcing, and monitoring criteria relevant for ASEAN unity, as well as for stability in the South and East China Seas, the Taiwan Strait and the Korean Peninsula. The EU could also further develop its visibility and role in the ASEAN Regional Forum, and support and strengthen ties with institutions related to the East Asia Summit and the ASEAN Defence Ministers' Meeting+8.
- The EU could also take a balanced approach to the US-China security relationship in East Asia by refraining on the one hand from lifting the arms embargo against China, and on the other hand from becoming directly involved in Washington's current build-up of military and diplomatic pressure on China.

THE VIEW FROM THE EU

Mattias Lentz[1]

When HR/VP Catherine Ashton hosts the fourth round of the EU-China Strategic Dialogue later this year, she will have a new Chinese counterpart across the table. State Councillor Dai Bingguo, her co-chair for the first three rounds, will then have retired, and a new State Councillor for Foreign Affairs, a new Defence Minister and a new Foreign Minister will all have taken office.

The National People's Congress (NPC) session in March 2013 concluded a five-month period, that began with the 18th Communist Party Congress in November last year, of leadership transition. We have seen the complete transfer of power from Hu Jintao and Wen Jiabao to the new President Xi Jinping and the new Premier Li Keqiang. Right now it is too early to say much about what the new leadership will mean in terms of policies for the country. Most agree, however, that continuity can be expected, at least in the short run.

This would likely apply also in the field of foreign and security policy. One of the questions many have asked, however, is whether foreign policy as a portofolio should not be reintroduced into the Central Committee Politburo, as it was for example when Zhou Enlai was Foreign Minister. Because even if Chinese foreign policy is not set to greatly change, foreign policy challenges will grow. How will these challenges be handled without an overarching coordinating mechanism at a sufficiently high level, something that is currently lacking in the Chinese Party and Government system? If any changes are made by the new leadership, they could have consequences for the EU-China Strategic Dialogue.

After three rounds already our Strategic Dialogue has been firmly established, and is the mechanism on which the first pillar (of our three-pillar comprehensive strategic partnership) is based. So even if the Chinese interlocutors are new, we expect continuity when it comes to the Strategic Dialogue.

But we also expect a continued widening and strengthening of our strategic cooperation within the fields of security, foreign and defence policy. The Dialogue has been developed over the years, and is now complemented and supported by a new, and important, defence and security dialogue; a crisis management consultation mechanism; the Political Directors' dialogue; and by regular consultations between EUSRs and their Chinese counterparts. This year, as was agreed at the Strategic Dialogue in July last year, we will also organise for the first time a High Level Seminar on Defence

1. Head of the Political Section, EU Delegation to China, Beijing. The views and opinions expressed in this article are those of the author and do not in any way represent the official view of the European Union and the European Commission.

and Security. To engage with China on defence matters has been made possible by the unique 'double hatting' of the HR/VP, chairing, as she does, both the meetings of EU member state Foreign Ministers and Defence Ministers.

So, whomever HR/VP Ashton will meet at the next dialogue round, we are confident that their discussions will help bring understanding and cooperation forward.

There is a clear need for this. The EU and China share common strategic interests. We are also faced with common global and regional challenges. Both the EU and China are convinced of the need to establish a system of effective multilateralism, and we both support the development of regional cooperation. We therefore hope to expand consultations in international fora. We would like to promote mutual support for our respective agendas, with a view to eventually developing joint initiatives. These could cover traditional as well non-traditional security threats, and defence- and security-related matters such as disarmament, non-proliferation issues, arms control and cybersecurity issues. Water security is another issue which will inevitably grow in importance, and where there is scope for far-reaching coordination and cooperation between the EU and China.

The Strategic Dialogue provides an opportunity to discuss international and regional issues of mutual concern; such as Syria, developments in the Middle East and in North Africa, in Burma/Myanmar and on the Korean Peninsula. Off the coast of Somalia, in the Gulf of Aden, Chinese and European navies cooperate to battle piracy. In the E3+3 format, the EU has cooperated well with China, and China's leading role in the Six Party Talks on the Korean Peninsula is recognised and appreciated. But we believe that the dialogues can both be intensified and become more focused. We now need to achieve more concrete results.

But to move forward, China will need to better understand, and to recognise, that the EU is a legitimate and valuable partner in matters pertaining to security and foreign policy. Today, when the EU is still seen mainly as a trading partner, that is not always the case. It is true that the EU does not have a leading role in 'hard' security issues in the region. But China needs to realise that the EU has a clear strategic interest in keeping regional maritime conflicts in the East and South China Seas under control. Or, equally, that the EU could be a useful contributor in reducing tensions on the Korean Peninsula. The EU and China could cooperate in other problematic areas in Asia to foster peaceful development in the region; Afghanistan seems an obvious example. The EU will seek to be a constructive and engaged partner, not a threatening one.

The EU would welcome the prospect of China playing a greater role in global issues. China and the EU can cooperate to contribute to resolving global and regional problems, and could together become a force for stability and peace not only in Asia but in other parts of the world.

VI. POLITICS AND STRATEGY

KEY ISSUES OF CHINA'S LEADERSHIP SUCCESSION AND THEIR RELEVANCE TO THE EU

François Godement

Introduction

After a decade of consolidating collective leadership, harmony and what many foreign observers have taken to calling the 'black box' approach of top level Chinese decision-making, the leadership changeover which took place in November 2012 is proving interesting. One might even go as far as to claim that the People's Republic of China (PRC) has reached a turning point in its politics and history .

It is true that there is a risk that developments inside the Chinese Communist Party (CCP) leadership are liable to over-interpretation. Silence on important issues – particularly glaring with regard to the disappearance from public of China's presumed next leader, Xi Jinping, for two weeks at the beginning of September – only creates a rumour mill. It is now as if an 'echo box' in society at large is beginning to balance out the 'black box' of insider elite politics. The universal spread of social media – with even striking workers and local activists now making regular use of it – is changing both public opinion and the terms in which politics is conducted inside China. A process of asymmetric political liberalisation over the past two decades – with nationalist activists having been tolerated while pro-democracy activists are still being repressed – means that the influence of nationalist thinking on the population at large may be open to exaggeration.

In addition to politics there are other factors at play. China's former President and Premier, Hu Jinatao and Wen Jiabao, deserve praise for the extraordinary success they achieved on the economic front, and in positioning China as an international actor of the first rank. Rising to become the world's second-largest economy (third if one counts the EU as a single entity), and maintaining economic momentum in the face of a series of international crises, are no mean feats. Yet the former Hu-Wen Administration is very often criticised in China for its timidity or ambiguity in addressing some of the more pressing issues. This criticism comes from both the 'left' (nationalist or populist advocates of a stronger state) and also from the 'right' (liberals and constitutionalists who want to speed up the process of legal, political and economic reform).

There is a growing realisation that the success of the current system may be reaching its own limits. China's export-oriented economy, its policy of financial repression that has led it to hold the world's largest stock of foreign currency reserves, and the rise of state-led industrial giants and special interests groups such as finance and real estate lobbies, have now begun to stunt further growth. The later the causes of this slowdown are tackled, the harder they will be to fix in the long run.

At the same time there is also a growing expectations gap in China. China's nationalists do not see why the country – with its new international leverage and ever-rising military budget – cannot achieve its historical irredentist goals and reclaim lost territories. This expectations gap explains the quasi-simultaneous clashes which recurred in the summer of 2012 with the Philippines and Japan. 'China is a big country', the Foreign Minister of the PRC, Yang Jiechi, declared euphemistically to a gathering of his ASEAN counterparts in July 2010. Since then, China has proceeded to prove this claim, demonstrating force in both the South and East China Seas.

A crisis of expectations in China

The crisis of expectations is also becoming evident in the socioeconomic field. After several decades of stagnation, real industrial wages in China have started rising, first in 2008 and again since 2011. The reasons for this have included: local labour shortages, an investment boom complementing the export boom, and the decision by higher authorities to let industrial developments take their course, particularly in factories belonging to big foreign companies.

Yet the steeply rising cost of food, accommodation and housing, which in reality is far beyond China's official price indexes, is cancelling out many of the income gains that accompanied these wage increases. As a result, income gaps and inequality are becoming more evident, and indeed more commented on. Furthermore, studies on 'grey' or undeclared income – demonstrating that China's GDP is underestimated by perhaps as much as 15 percent, and that untaxed or 'hidden' income is almost entirely concentrated in rich urban households (the top 2 percent of China's population) – are also helping to reveal that China's low ratio of individual income to GDP is in fact a myth. Indeed there are two Chinas: a China of low-paid rural and contract workers which is still expanding in the hinterland and is the source of industrial competitiveness abroad; and a China of new affluent middle classes who live off the transactional economy and, more often than not, profit economically from a privileged status, tax exemptions (prevalent in real estate) and also corruption or rent-seeking.

It is these developments that explain why the leadership succession took place in a climate that combines a glowing sense of achievement with a gnawing feeling of insecurity. The difficulties inherent in the process of rebalancing power while at the same time creating 'checks without balances' inside the single-party state bedevilled the political succession process last autumn.

There are more questions than answers regarding several of the difficulties that China is now facing, even if these difficulties are of its own doing rather than the consequences of international trends. There are currently three main issues primarily influencing the political climate in the PRC in the aftermath of the leadership transition.

The rule of law

The conflict between advocates of the rule of law and hardliners in the security and propaganda apparatus is now starkly obvious. Former Prime Minister Wen Jiabao had repeatedly addressed the issue, supporting the reformers and suggesting that the transition should speed up and become a top-down process. He had also made his position clear by explicitly stating that 'absolutely no one is above the law' and by warning of the risk of another Cultural Revolution. Meanwhile, incidents such as the detention of Ai Weiwei in 2011 or the Chen Guangcheng saga in 2012 have drawn worldwide attention to the very powerful, not to say repressive, nature of the Chinese security apparatus. In 2011-2012, the public debate over a new criminal procedural code exposed a conflict between advocates of the rule of law and due process, and those who stood, among other things, for arbitrary and secret detention for a variety of offences. Despite this fact, we should be careful not to demonise China. There are several states in South-East Asia which can be categorised as semi-democratic, or indeed semi-authoritarian, and that have kept provisions in domestic security legislation to allow for arbitrary detention. That said, however, nowhere is the detention process as secret or as opaque as in China. Following the persecution of Ai Weiwei and Chen Guangcheng, the fate of a Politburo member and some of his close associates serves as a reminder of the limits of the rule of law in the Chinese state. Among the newly-appointed top leadership or influential party elders it is difficult to identify where each individual stands on this issue. It is clear, however, that opposing camps have already begun to form.

Economic reform

The debate between those who argue for continued state-led economic growth and those who advocate the need for liberalising reforms that replace topdown administration with regulatory competition, has also taken on strong political overtones. There are now clear battlelines being drawn between the old guard and those who believe in curtailing the growth of state firms, infrastructure and investment in favour of smaller private firms, entrepreneurial innovation and individual demands. On the one hand, the World Bank's 'China 2030' report, publicly endorsed by a State Council think tank, prescribes further steps towards economic reform. On the other hand, the Chongqing model of huge public investment to help draw in

Chinese and foreign firms, along with larger social expenditures, suggests an alternative future where the success of an essentially non-market economy lies in its capacity to control and mobilise the factors of production; it is socialism writ large in the era of globalisation. The debate is further complicated by the fact that advocates of China's reform also have a comprehensive plan to introduce social welfare (including health insurance and retirement pensions) to the very bottom rungs of Chinese society – right down to the rural households who have never been directly provided for by the central state. While China's populists and 'new left' accuses liberal policies of fostering income inequality and graft, the liberals counter that it is the unfinished process of reform and transition that has encouraged rent-seeking and corruption.

Foreign policy

Foreign policy has become a minefield since late 2009. This is perhaps the most surprising development of all, since foreign policy and security are, in general, the most tightly controlled sectors of public life in China. An explanation is often put forward by officials or experts that the new generation of Chinese citizens is increasingly vocal and patriotic. The liberalisation of public and social media has fanned the flames of active nationalism, exercising pressure on the actions of the government. This may be more of a self-fulfilling prophecy than an actual explanation of what is going on. China's ideologically biased education system and tightly controlled media have encouraged the spread of patriotism and nationalism since the early 1990s to counteract Westernising and democratising forces in Chinese society. Key institutions of the one-party state – from the People's Daily group to some defence bodies – support this wave of nationalism. The real issue is whether these developments are the consequence of a genuine, top-down plan to promote nationalism as an ideological bulwark and a foreign policy tool, or whether there are also conflicting views among the many bureaucracies that craft the foreign policy of this country with its newly acquired big power status. Disputes – with ASEAN members or with Japan – seem to be cyclical in nature, which would suggest an alternation between periods of restraint and periods of deliberately encouraged tensions. Two factors still curb a serious escalation in violence: China's use of hard power military means is extremely, if not totally, limited – with all incidents involving at the most semi-militarised organisations such as coastguards that are unlikely to lead to a spiral of escalation (some encounters between Chinese submarines and the US Pacific Fleet are the exception to this, but they are not directly linked to territorial disputes). More generally, China is able to preserve a foreign policy posture of moderation and reform: its policies towards the European Union and global financial organisations are key examples.

It should also be noted that positive developments and reforms still continue in some sectors that seem to be insulated from the general upheaval of the leadership succession. China's progress in the field of alternative energies is impressive, even if it can also be construed as a niche market for exports and this involves questions about fair competition. The development of the Chinese financial market and a limited experiment in the internationalisation of the renminbi (RMB) also continue to advance.

What next?

All of this has a number of implications for EU-China relations.

First, the European Union should count its blessings that it is a non-strategic partner of China, notwithstanding all declarations to the contrary. Europe is not directly involved in territorial claims involving China (although it would find it difficult to stand completely aside if peace was breached). There is a risk, however, that Europe may make a virtue out of necessity. Decreasing defence resources, combat fatigue after the experiences of Iraq and/or Afghanistan, fears of new crises in North Africa and the Near East, and public preoccupation with the economic crisis may lead to a perception of Europe as a 'soft power' partner concerned largely with norms on transversal issues such as the environment, or with direct trading interests, broken up along member state lines.

Second, it is trends, rather than human agency, that are balancing out the trade and economic exchanges at the core of the relationship. The euro's devaluation, the recession in some eurozone economies that are big consumers of low-end Chinese products, and the temporary gap in public debt financing in some instances have all served to rebalance EU-China flows. This is in sharp contrast with the ever-growing trade imbalance between China and the United States – but it should be remembered that the EU-China curve is not the result of a premeditated Chinese policy, and a resumption of European growth would again challenge this trend.

Third, there are two Chinese policies that directly influence the relationship with the EU. One is a moderate redistribution of new currency reserves (as opposed to existing assets) to lessen the dependency on dollar reserves. A second policy is to move outward FDI from developing economies to the developed world: because Europe was perceived to have a more porous and less politically driven investment climate, it benefited disproportionately from this new investment drive in 2011 and 2012. One policy which has not changed, however, is the focus of Chinese investment on energy and raw materials: therefore the sectors targeted in Europe are predominantly linked to this policy, just as they are in developing economies. These investments, from 2009 to 2012, have moved from Europe's periphery to its core. The European Union has to find a balance between encouraging these investments, which rebalance the relationship, and the need for safeguards and regulation where the peculiar nature of China's non-market economy may give it undue advantage – or undue influence.

Fourth, Europeans must both recognise the role of former Chinese leaders who have sometimes invested energy in the relationship, and be prepared to work with a new cohort of party leaders who may have a different approach. There is a (not wholly justified) perception in China that Europe is increasingly dependent on China for capital, while Europeans over the past few years have generally agreed that a more unified and coordinated China policy was a prerequisite to deal with such a strong strategic actor. What is certain is that unilateral European concessions, or member state competition in policy areas, increase the leverage of talented Chinese negotiators. Whatever the actual divisions inside China's Party state, it is clear that there is a debate between those who think in terms of the developed economies being in inexorable decline, and those who on the contrary think that China will benefit by adopting standards and policies from abroad. At this critical juncture in China's political trajectory, major foreign partners should stay open but also true to their values.

The EU's position *vis-à-vis* China is both unique and fragile. Unique, because there is no direct conflict of geopolitical interest, and because China's concern to keep its partnerships open and diversify its main trading and political relationships demonstrates its need for Europe as a partner. Present trends in fact appear to favour a more balanced relationship. But it is fragile for two reasons. Europe is no longer a significant hard power in the Asia-Pacific, yet it has major security interests in the region: peace and freedom of navigation, non-proliferation, burden-sharing in global governance, and the promotion of human rights as a condition for open intersocietal exchange. And the process of European construction has left several competences midpoint between member state and intergovernmental or Commission levels. In spite of China's well-known difficulties with local administration, its central state has the power to control and mobilise actors in key areas. As a realist power, China has neither the inclination to consider Europe's geopolitical influence at a time when Europe is struggling with an ongoing economic and political crisis, nor the incentive to favour a more united and empowered Europe that would also be a more effective negotiator with China.

Europeans should support the EU's competences where they already exist – in trade, investment and the environment for example. And they should reinforce them, with a clarification as to their goals, in areas where they have recently appeared – such as the common foreign and security policy (CFSP). National shortcuts are very tempting, but they will weaken the EU's hand as a whole, and if such an approach is pursued Europe will never receive the kind of recognition from China that a united continent of 500 million people can expect to command.

THE VIEW FROM THE EU

Rebecca Fabrizi[1]

It is difficult to say with any certainty now what the leadership transition means for the EU and for policies towards China. Changes in policy will be quite subtle and evolve slowly. China's leaders do not get picked for advocating major changes, as the case of Bo Xilai has demonstrated so well. Nonetheless, our interests remain in seeking a prosperous China that is a source of prosperity for the EU too: a China that is more engaged internationally; and a China which effects the reforms necessary to ensure stable growth, in a fair and transparent society with functioning rule of law, where individual rights and freedoms are respected and defended. Our relationship is in a good place, after two successful Summits in 2012, rich in substance and conducted in a warm atmosphere.

We will continue to work in the 3-pillar framework. Our political relationship is still in its early stages. The Strategic Dialogue of 2012 secured important outcomes, reinforced at the 15th Summit, including commitment to a regular dialogue on security and defence matters, and to regular contacts between the EU Special Representatives and Chinese interlocutors. There is plenty of scope to develop this area, building on the high levels of political engagement in Asia demonstrated by EU leaders over the last year. Trade and Investment is obviously a top priority for the EU, China's largest trading partner. We want to get the High-Level Economic and Trade Dialogue back on track. We have clear and challenging objectives with regard to market access, public procurement, export credits, a level playing field for business, and intellectual property rights (IPR). The bilateral investment agreement that we have agreed to pursue with China should help us make significant progress, provided that it includes all of the issues of interest to both sides. There is also a range of sectoral issues that we will pursue and develop, including the urbanisation partnership, and we will focus on green development, a big priority for the EU and China. For the third pillar, we place a high value on cultural and public diplomacy. The EU's soft power is a great asset for us: EU countries have always shaped culture way beyond our own neighbourhood, and continue to do so. We will be looking at how to use this special character and expertise of the EU to make progress on business objectives in the creative industries, in developing people-to-people contacts, and in conveying a strong message on freedom of expression. With regard to our pursuit of proper respect for universal values and human rights, we will continue to engage and challenge China on these questions, and to offer EU expertise where we can. We hope to establish a new dialogue on the rule of law – an area in which we and some of our member states have had very positive and constructive experiences working with China.

1. Head of Division for China at the European External Action Service. The views and opinions expressed in this article are those of the author and do not in any way represent the official view of the European Union and the European Commission.

If we are to make an impact as the EU we must be united. China has shown us strong support through the difficult period since 2008, and clearly a strong and united Europe is in China's interest. There is a unity of purpose among EU countries and agreement on shared objectives towards China, and we will work to maintain this and to ensure synergy between action at the EU and at the member state level. From the institutional perspective we support strong bilateral relationships between individual member states and China – these support our own engagement. We will continue to work with the member states to ensure excellent communication, cross-fertilisation of ideas, and coordination on approaches and messaging, to make sure that we formulate the right policies and make the right impact in the coming months and years.

VII. THE REGIONAL CONTEXT

EU-JAPAN RELATIONS AND THE 'CHINA FACTOR'

Axel Berkofsky

Introduction

Back in 2001, Tokyo and Brussels had very ambitious on-paper plans for international economic, political and security cooperation. This was embodied in the EU-Japan Action Plan for Cooperation adopted in 2001 (hereafter referred to as the EU-Japan Action Plan).[1] However, to date, only a few of the envisioned joint policies in the areas of global and regional politics and security have actually been implemented and European and Japanese policymakers acknowledge that the Action Plan suffered from a lack of focus, seeking to deal with too many issues and areas without sufficient resources and political will.[2] As regards the institutionalised future of EU-Japan cooperation, at the May 2011 EU-Japan Summit, Brussels and Tokyo agreed to start negotiating two separate new cooperation agreements, one covering politics and security and the other covering trade and investment, including a possible bilateral Free Trade Agreement (FTA). Brussels and Tokyo have over the last ten years established a framework for regular consultations and bilateral meetings dealing with many issues of international politics and security.

This chapter examines current and envisioned EU-Japan security cooperation with the aim to assess what impact the intensification of European-Japanese relations in the area of security have, and do not have, on EU-China relations. In other words, it pieces together an analysis of the 'China factor' in the context of EU-Japan relations in general, and security relations in particular.

EU-Japan security cooperation

EU-Japan cooperation on security issues focuses on non-military (or what is referred to as 'alternative') security cooperation, i.e. security cooperation using financial and

1. See 'An Action Plan for EU-Japan Cooperation: Shaping our Common Future', Japanese Ministry of Foreign Affairs. Available at: www.mofa.go.jp/mofaj/area/eu/kodo_k_e.html.

2. For a detailed analysis of EU-Japan relations see also Axel Berkofsky, 'EU-Japan Relations from 2001 to today: achievements, failures and prospects', in *Japan Forum*, vol. 24, no. 3, September 2012, pp.265-89; also Axel Berkofsky, 'True strategic partnership or rhetorical window-dressing: a closer look at the relationship between the EU and Japan' in *Japan aktuell*, no. 2, 2008, Institut fuer Asienkunde, Hamburg, pp. 22-8.

economic resources to contribute to peace and stability through ODA and other forms of development and financial aid. However, non-military and non-combat security cooperation with the EU continues to complement Tokyo's close military security cooperation with the US to only a very limited degree.

In September 2005 Brussels and Tokyo began discussing Asian security issues on a regular institutionalised basis by launching the EU-Japan Strategic Dialogue on East Asian Security.[3] The establishment of this dialogue was preceded by the establishment of the EU-US Dialogue on East Asian Security in 2004 and given that the EU weapons embargo imposed on China in 1989 was the central issue on the dialogue's agenda, it is fair to conclude that the motivation for Tokyo to initiate regular exchanges on East Asian security in the framework of that dialogue was identical with Washington's motivations in 2004: institutionalising political pressure on Brussels not to lift the weapons embargo imposed on China after Tiananmen square in 1989. In the mid-2000s Tokyo and Washington feared (unnecessarily, as the lifting of the embargo was, due to the lack of consensus among EU members, realistically never an option for the EU) that Brussels would lift the embargo, and begin exporting weapons and military technology to China, thereby actively supporting Beijing's efforts to modernise its armed forces.

In retrospect, especially in view of the fact that neither Tokyo nor Washington ever planned to include the EU in their respective security strategies for East Asia beyond informal consultations, it is fair to conclude that without Chinese pressure to lift the weapons embargo (and US-Japanese pressure not to do so), neither Japan nor the US would have had any incentive to propose establishing a dialogue on East Asian security with the EU.[4]

Cooperation in Afghanistan and Somalia

In November 2009, then Japanese Prime Minister Hatoyama Yukio announced a Japanese contribution of US$5 billion towards the reconstruction of Afghanistan over the following three to four years. Tokyo provides the funds for infrastructure and humanitarian assistance in Afghanistan. Some of the Japanese funds assigned to Afghanistan will be spent on joint projects with the EU in the years ahead. With reference to the EU's October 2009 Action Plan for Afghanistan and Pakistan and Japan's November 2009 assistance package for Afghanistan, Brussels and Tokyo envision (as formulated in the joint press statement issued after the April 2010 EU-Japan Summit in Tokyo) joint capacity-building assistance for the Afghan police in the Afghan province of Ghor. However, although joint EU-Japan police training in Afghanistan was first discussed almost two years ago, it has yet to materialise.

3. For details see also Olena Mykal, 'The EU-Japan Security Dialogue: Invisible but Comprehensive', Amsterdam University Press, 2011

4. EU policymakers and officials, of course, disagree with this conclusion and argue (as they did when speaking with the author) that both Japan and the US were interested in discussing their respective regional security policy strategies with the EU.

As regards EU-Japan counter-piracy cooperation off the coast of Somalia and the Gulf of Aden, Japan's Maritime Self-Defence Forces and the EU Naval Force (NAVFOR) Somalia Operation *Atalanta* have, since 2010, exchanged information on numerous occasions.[5] However, to refer to EU-Japan data-sharing as a 'joint EU-Japan mission' (as the EU and Tokyo have repeatedly done) is only accurate up to a point as this data-sharing takes place in the framework of a multinational and UN-sanctioned mission combating piracy off the coast of Somalia. Furthermore, Tokyo and Brussels announced in April 2010 that they would jointly support the establishment of the Djibouti counter-piracy regional training centre and information-sharing centres in Kenya, Tanzania and Yemen.

After the April 2010 EU-Japan Summit, Brussels and Tokyo set up the EU-Japan Joint High-Level Group (HLG), tasked with discussing and eventually developing the format of a new bilateral EU-Japan framework agreement.[6] Bilateral security cooperation featured on the group's agenda and the EU suggested setting up a Framework Participation Agreement to institutionalise a Japanese civilian contribution to EU CSDP missions.

The 'China factor'

Bilateral EU-Japan consultations and cooperation in areas also of interest to China such as Asian regional security in general and the below-mentioned Asian territorial disputes in particular, could have an impact on Beijing's willingness to cooperate with Brussels – even if this is cooperation only for the sake of marginalising Japan and limiting EU support of Japanese Asian security policies in general and Tokyo's policies on disputed territories in the East China Sea in particular.[7]

Under the current circumstances, however, a scenario of Japan and China entering into 'competition' over cooperation with the EU in Asian security is probably not realistic given that the EU is only considered to be a relevant actor in Asia security within certain limits. What is more, China's interest and willingness to cooperate and consult with others on Asian security is and will continue to be very limited (if existent at all), not least as Beijing is either directly or indirectly involved in the relevant and potentially explosive security issues in the region: territorial conflicts in the East China and South China Seas, security in the Taiwan Straits and the status of Taiwan as well as North Korea's missile and nuclear programmes.

5. EU NAVFOR's main tasks are to escort merchant vessels carrying humanitarian aid for the World Food Programme, to protect ships in the Gulf of Aden and the Indian Ocean, and to deter and disrupt piracy. EU NAVFOR also monitors fishing activity off the coast of Somalia. For further details see: http://www.eunavfor.eu.

6. On some details of the tasks and motivations for setting up the High-Level Group, see the Joint Press Statement of the 2010 EU-Japan Summit: 19th EU-Japan Summit Tokyo, 28 April 2010. Available at: http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/er/114063.pdf.

7. These are the since 1895 Japanese-controlled Senkaku Islands (Diaoyu Islands in Chinese). To be sure, both Tokyo and China insist that there is no territorial conflict. The Senkaku Islands belong to Japan and the Diaoyu Islands belong to China, Tokyo and Beijing insist respectively.

(Too) quiet diplomacy

Given that the EU's strategic interests in Asia (as compared to e.g. US interests) are arguably limited, the EU's decision not to get involved in Japanese-Chinese political and diplomatic tensions over disputed territories in the East China Sea is understandable to a certain extent. However, in Asia Brussels' 'quiet diplomacy' on security issues in the region is more often than not perceived as too 'quiet' and there is a general feeling that the EU does not sufficiently live up to its own ambitions of being a foreign and security policy actor with global reach, including in Asia.

At the height of Japanese-Chinese territorial disputes in the East China Sea in September 2012, Catherine Ashton, High Representative of the Union for Foreign Affairs and Security Policy, 'urged all parties concerned to seek peaceful and cooperative solutions in accordance with international law, in particular the UN Convention on the Law of the Sea' (this statement was followed by another Ashton statement on 25 September calling on 'all parties to take steps to calm the situation'). Hence, the EU did not (at least not publicly) take sides and limited itself to assuming a neutral role from a distance – 'neutral' in the sense that Brussels did not attempt to assume a mediator's role beyond urging all involved parties not to allow territorial disputes to develop into more than a bilateral Japanese-Chinese diplomatic crisis.

To be fair, what else could the EU have said and what impact could a more robust response to Chinese intrusions into Japanese-controlled territorial waters have had? Judging by how Beijing typically reacts to other countries commenting or criticising its foreign policies, Brussels would most probably have been accused of 'interfering in China's internal affairs' if had openly and outspokenly criticised the intrusion by Chinese navy vessels into Japanese-controlled territorial waters. Then again, a more robust EU response to increasingly aggressive China policies related to territorial claims in the East and South China Seas could have sent a message to both Tokyo and Beijing that Brussels is not indifferent to Asian territorial disputes. Such a posture would have created a positive perception of the EU as a security actor in Asia; as it was, the EU was perceived as a weak player offering no more than a statement expressing 'concern' over Japanese-Chinese political and diplomatic tensions.

Perception matters in general and in Asia in particular and the EU response to and comments on Japanese-Chinese disputes in the East China Sea were perceived as weak, confirming the perception that EU influence on and involvement in Asian hard security issues is very limited at best and non-existent at worst.[8]

For Southeast Asian policymakers in particular the EU response and reactions to Chinese intrusions into Japanese-controlled territorial waters in the East China Sea throughout 2012 was a confirmation that those countries in the region disputing ter-

8. See e.g. Gauri Khandekar, 'EU quiet as trouble brews in Asia', in *EUObserver.com*, 18 September 2012.

ritories with China in the South China Sea (e.g. Vietnam, the Philippines, Indonesia, Brunei, Malaysia) cannot expect much from the EU in terms of robust support in the case of the continuation of aggressive Chinese policies related to disputed territories in the South China Sea.[9]

It is accurate to conclude that the EU is not perceived as a relevant (hard) security actor in Asia among Japanese foreign and security policymakers. Such a perception was undoubtedly confirmed during the controversy over the lifting of the EU China weapons embargo in the mid-2000s. Brussels' weapons embargo policies and the absence of an inner-EU consensus on whether or whether to lift the embargo or not gave Tokyo (and Washington for that matter) the impression that Brussels is prioritising business and trade ties with China over Asian and Japanese security and is hence not to be fully trusted as a security policy partner.

At a time when a possible lifting of the embargo was already all but off the EU foreign policy agenda, then Japanese Prime Minister Shinzo Abe urged the EU during a visit to Brussels in 2007 not to lift the weapons embargo. Leaving aside the fact that the Japanese Prime Minister was arguably ill-informed on the EU weapons embargo policies at the time, Abe in essence voiced concerns which from 2004-early 2007 were from a Japanese perspective understandable. Brussels, it was feared in Tokyo (and Washington back then), would allow European defence contractors to resume massive weapons and weapons technology exports to China, thereby supporting the rapid modernisation of China's armed forces at the expense of Japanese and Asian security.

What next?

Many times over the last ten years the EU has described Japan as Europe's 'natural political ally' without however sufficiently matching this political rhetoric on envisioned cooperation with actual on-the-ground cooperation in the area of security. Japan too talked much more in the past decade about expanding political and security cooperation with the EU, without however devoting enough resources to actually doing so.

Given Japan's volatile regional security environment and perceived threats from North Korea and China, Tokyo will continue to depend on the US military presence in East Asia for its security, thereby ensuring that a diversification of Tokyo's foreign and security policies, including the intensification of security cooperation with the EU announced by Tokyo in the early 2000s[10], remains a very marginal issue on Japan's security and defence policy agenda.

9. Author's interviews with policymakers and government officials from Vietnam, the Philippines, Singapore and Indonesia in 2012 allow for such a conclusion.

10. Japanese Prime Minister's Office (Kantei), 'Basic Strategies for Japan's Foreign Policy in the 21st Century New Era, New Vision, New Diplomacy', 28 November 2002, Task Force on Foreign Relations for the Prime Minister. Available at: http://www.kantei.go.jp/foreign/policy/2002/1128tf_e.html.

Given its ambitions to expand political, business and institutional relations with China, the EU is not always perceived in Tokyo as a fully reliable, staunch and outspoken enough supporter of Japanese policies related to territorial disputes with China in the East China Sea. Consequently, the US – and the US only – will continue to be perceived as a relevant and suitable partner for Japan and defender of Japanese territorial integrity in the East China Sea. Indeed, the EU's decision not to have a more outspoken position on territorial disputes caused by Chinese intrusions into Japanese-controlled territorial waters around the Senkaku Islands in the East China Sea must have confirmed Japanese policymakers' view that Brussels will continue to have to be treated as security policy actor only in a selected number of areas, such as the above-mentioned civilian security cooperation in Afghanistan.

In the early to the late-2000s, expanding relations and cooperation with Beijing was clearly at the very top of Brussels' Asia foreign and security policy agenda, even though it became clear that Brussels and Beijing had very little in common as regards approaches towards international politics and security. Indeed, European and Chinese policies and priorities have often been fundamentally different, be it in Africa, Central Asia or other regions and countries where Chinese policies were, and still are, above all driven by the goal of securing supplies of energy and other natural resources. What is more, China's willingness to cooperate in politics and security with the EU depended on the latter's preparedness to give Beijing what it most wanted from Brussels: the lifting of the EU's arms embargo, imposed on China in 1989, and Brussels' recognition of China's market economy status (MES) under WTO rules – neither of which has happened yet.

THE VIEW FROM THE EU

Michael Reiterer[1]

The Asia Pacific region has become central to global prosperity. Consequently, the region's security and stability matter even more now than before. China and Japan, together with South Korea, are the major Asian economic powerhouses.

Unlike Axel Berkofsky I hold the view that the EU as the world's largest economy and trading bloc has essential security interests in the whole of Asia. This is borne out by the fact that four of the EU's ten strategic partnerships are with Asian countries: China, India, Japan and South Korea. Furthermore, two other key strategic partners of the EU, the US and Russia, have special interests in the region. Last year the EU and the US issued a Joint Statement on the Asia Pacific,[2] while the EU has established regular consultations with Russia on the region. ASEAN is a longstanding dialogue partner and embodies one of the distinctive features of EU foreign policy: multilateralism.

The EU's economic presence in the region and its unique experience of post-war reconciliation and political and economic integration, mean that it is well-positioned to play a role in helping to bolster regional security. In the context of the 'US pivot' and China's rise a number of the states in the region have signalled that they would welcome enhanced EU engagement in order to complement US presence and influence. While the US has to explain that its 'pivot' is not only military, the EU is not regarded in the same way as it relies primarily on its soft/smart power. The EU is aware that it is perceived by many Asian partners primarily as an economic power, and not yet as a political/strategic one, despite its importance for global economic governance, its economic bargaining strength and its engagement in Asia through the CFSP and ESDP. Consequently, in order to enhance the Europe-Asia economic partnership, 'the EU has to add the political dimension to the economic one'[3] – e.g. in terms of content to develop relations beyond trade and in terms of geography to develop relations beyond China.

Contrary to popular perception, in pursuing this goal the EU does not have to start from zero: it is committed to cultivating closer links with ASEAN, as evidenced in the 2012 Bandar Seri Plan of Action. The EU has also recently earmarked €40 million to support ASEAN as the EU recognises and supports the centrality of this organisa-

1. Senior Advisor at the Asia and Pacific Department in the European External Action Service. The views and opinions expressed in this article are those of the author and do not in any way represent the official view of the European Union and the European Commission.

2. 'Joint EU-US Statement on the Asia-Pacific region', Phnom Penh, July 2012. Available at: http://consilium.europa.eu/uedocs/cms_data/docs/pressdata/EN/foraff/131709.pdf .

3. Michael Reiterer, 'Asia-Europe: Prospects after the Crisis', in Michael Gehler, Xuewu Gu and Andreas Schimmelpfennig (eds.), *EU-China: Global Players in a Complex World* (Hildesheim: Olms, 2012), p. 284.

tion in the emerging regional institutional architecture. Hence the EU has expressed its interest in participating in the East Asia Summit (EAS) as well as in the enlarged ASEAN Defence Ministers Meeting Plus (ADMM+). The EAS seems well placed to assume more responsibility in managing the region and to become a high-level security forum, supplementing the ministerial ASEAN Regional Forum (ARF) in which the EU participates as the Union.

This relationship with ASEAN and the Asia Europe Meeting (ASEM) set up in 1996 offer a comprehensive and not just trade-related platform for high-level dialogue between the two regions. The ever-increasing number of participants in ASEM indicates the importance attributed to the deepening of the relationship, which for many Asian partners is complementary to their participation in APEC.

Some official documents published in the last few years allow us to better understand EU strategic priorities and objectives in Asia. The 2001 Strategy Paper *Europe and Asia*, building on its 1994 precursor, identified six objectives for EU-Asia cooperation including enhanced engagement with the region to contribute to peace and security; strengthened mutual trade and investment flows; development cooperation and eradication of poverty; contribution to the protection of human rights, the spread of democracy, good governance and the rule of law; fostering global governance and environmental protection; and raising mutual awareness. Concrete cooperation and policy approaches with Asian sub-regions and countries have been developed through a series of new Communications on South-East Asia, India and China.

The 2003 *European Security Strategy* (ESS) highlighted the importance of the Asia-Pacific region,[4] while the 2007 *Guidelines on the EU's Foreign and Security Policy in East Asia* (updated in 2012) are a clear indication of the EU's political and strategic interests in the whole region. The updated *Guidelines* underline the geostrategic importance of the region, dealing with new hotspots such as the territorial and maritime disputes in the South China Sea.[5]

Building upon these *Guidelines* and in recognition of the EU's 'significant interests in the region', in September 2012 the High Representative issued a statement urging 'all parties concerned to seek peaceful and cooperative solutions in accordance with international law, in particular the UN Convention on the Law of the Sea and to clarify the basis for their claims. The EU calls on all parties to take steps to calm the situation.'[6] Thus, while carefully avoiding taking sides this declaration is a clear indication of the EU's interest and points to the foreign policy instruments favoured by the EU, i.e. peaceful settlement of disputes. Attempting to take on a role as mediator in the territorial

4. See 'The European Security Strategy: A Secure Europe in a Better World', Brussels, December 2003. Available at: http://www.consilium.europa.eu/uedocs/cmsUpload/78367.pdf. The 2008 Report on the Implementation of the Strategy deals with Central Asia but barely with the rest of Asia, apart from a reference to fighting crime in South Asia: http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressdata/EN/reports/104630.pdf.

5. See: http://eeas.europa.eu/asia/docs/guidelines_eu_foreign_sec_pol_east_asia_en.pdf.

6. See: http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/EN/foraff/132566.pdf .

and maritime disputes as advocated by Axel Berkofsky would be overestimating the EU's potential to exert influence beyond low intensity conflicts in Asia. However, offering its experience in the joint management of shared resources as well as in conflict management and resolution corresponds to the EU's vocation as a smart power.

The EU-China relationship

Already in 1995 the Commission foresaw that China would be 'a cornerstone in Europe's external relations, both in Asia and globally' and advocated constructive engagement. In 2001 the 1998 Comprehensive Partnership was reviewed, leading in 2003 to the 'Maturing Partnership', which had as a counterpart China's 2003 'EU Policy Paper'[7] in which China foresaw close and broadly-based cooperation with the EU also envisaged as going beyond a purely trading relationship. The ESS finally upgraded the partnership from 'comprehensive' to 'strategic'. The 2012 Guidelines recommend that '*As strategic partners, the EU's approach should be one of frankness, more transparency, full reciprocity and enhanced bilateral ties*'.

The bilateral relationship between the EU and China is characterised by the EU's awareness of the rising importance of China as a key economic power at global level. China's economic success – attested by a growth rate of ten percent over three decades – translates into confidence and assertiveness in the political and economic spheres.

Internationally an open trading system and a stable financial system, including a stable euro which forms a significant part of Chinese foreign exchange reserves (about 30 percent corresponding to about seven percent of euro area debt) are important shared interests. China also has a strategic interest in maintaining the euro as the second world currency, to avoid US dollar hegemony in the international financial system. This will also facilitate the internationalisation and convertibility of the yuan which remains a mid-term goal as it would strengthen China's weight in international relations.

China has a vested interest in the stability of its largest export market. This necessitates mutual understanding, awareness and dialogues as well as adherence to international rules and regulations: in the area of trade these are in particular the rules of the WTO to which China adhered in 2002 with the strong support of the EU. The 2012 *Guidelines* underline that '*the current trend of trade imbalance between China and the EU is not sustainable in the longer term. Issues related to market access and intellectual property rights also persist*.'

Economic and trade interests cannot be treated in isolation, they extend to or translate into political, geostrategic interests, which give rise to ensuing global responsi-

7. See: http://www.fmprc.gov.cn/eng/topics/ceupp/t27708.htm.

bility: the EU and China have a common strategic interest in keeping the connecting sea lanes safe and open. For this reason China cooperates with the EU through the International Contact Group on Piracy off the Coast of Somalia in *Atalanta* and is keen to assist in defusing political tensions in strategically important hotspots such as in the straits of Hormuz or Malacca. Taking into account that China is also leading in the Shared Awareness and Deconflication (SHADE) initiative, a coordination mechanism for all counter-piracy operations which meets every three months. Within this context, China, India and Japan are coordinating military operations. It may be hoped that these positive examples of cooperation could serve as a solid basis for cooperation to ensure open lines of sea communication and the implementation of the rule of law in the various maritime disputes.

What next?

Asia is of increasing political, economic and security importance to the EU: the EU is the largest trading as well as investment partner for many countries in the region and therefore is actively engaged in the negotiation of partnership and free trade agreements to deepen political and economic ties. Furthermore, the Union contributes to the region as a major donor of development assistance – despite the shift of the political and economic focus to Asia, it is still home to millions of people living in absolute poverty.

In recognition of the political, economic and strategic importance of East Asia, the EU maintains traditionally close relations with the region on the bilateral and multilateral level. The EU became a signatory to the Treaty of Amity and Cooperation (TAC) in 2012 and is ready to contribute to making the East Asia Summit (EAS) an effective security player, once admitted. This is necessary as the lack of an institutional architecture capable of helping to diffuse tensions, and of either assisting in settling disputes or at least in managing them, is one of the major shortcomings in East Asia. Therefore, the present territorial and maritime disputes oscillate between the bilateral, regional and even global levels. This dysfunctionality could in the long run impact negatively on the economic development of the region, although interregional trade and cross investments have considerably increased over the last years, which in turn has potential negative repercussions on the EU.

In contrast to Asia, the EU provides Europe with an institutionalised supra-national structure for common policymaking. Asia also lacks an equivalent 'superstructure' or a canon of common values like good governance, the rule of law, democracy, and a social market economy. Furthermore, in addition to the EU's own newly introduced obligation to support a Member State in case of armed aggression, NATO provides a security umbrella and the OSCE a forum for dialogue. There are no comparable security structures in Asia – without wishing to minimise the role of the ARF or ASEAN in general: Neither the ARF, nor the EAS, nor the intra-regional ASEM have so far contributed effectively to finding a solution to the regional hotspots such as the Korean Peninsula, the Straits, tensions between India and Pakistan, various territorial and maritime claims, and the threat of nuclear proliferation.

Working with strategic partners and especially likeminded ones is a natural approach for an out-of-the-region power, like the EU. There are certainly areas of common interest with Japan. China, an important 'strategic partner of necessity'[8] given its importance by any measure, is in the primary focus of the EU's attention. Therefore the EU has further intensified its network of wide-ranging dialogue with China, e.g. in adding a security dialogue to the strategic one. The United States - another important strategic partner - remains an important force in the region. The FTA and the Framework Agreement with Korea will serve as a benchmark for other agreements, in particular the negotiations with Japan due to start in 2013.

In short, the EU will have to pursue a comprehensive Asia policy which is more than just a policy focused on China. It can bring its smart power to bear in combining bilateralism and regionalism, and developing a transnational approach which contributes to global governance through strengthened regional governance.

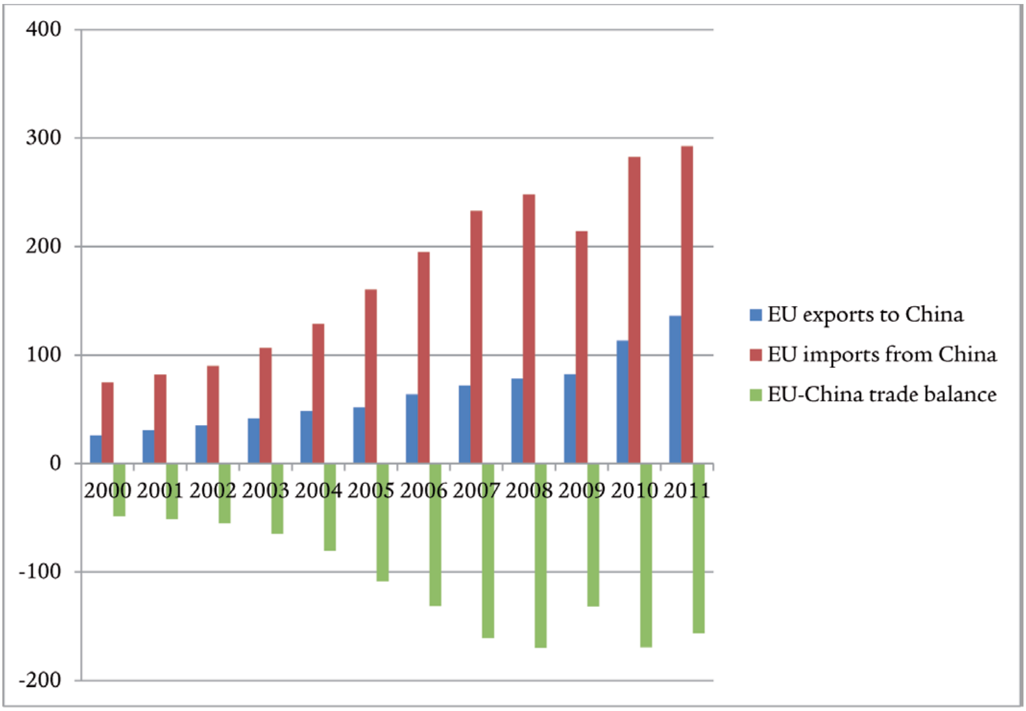
8. Michael Reiterer, 'The Role of 'Strategic Partnerships' in the EU's Relations with Asia', in Thomas Christiansen, Emil Kirchner and Philomena Murray (eds.), *The Palgrave Handbook of EU-Asia Relations*, (Basingstoke: Palgrave MacMillan: 2013), pp. 75-89.

ANNEXES

TABLES

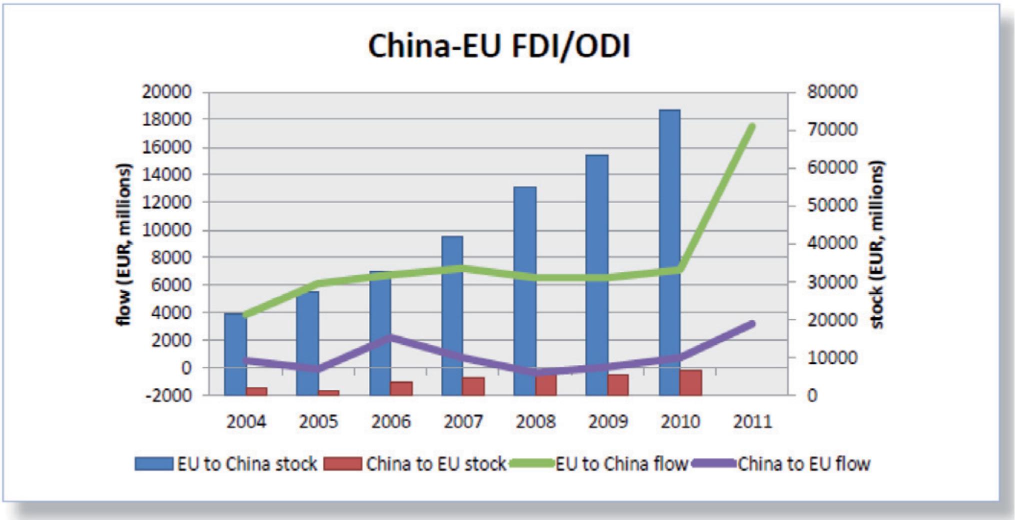
EU-27 trade in goods with China

in billions of euro

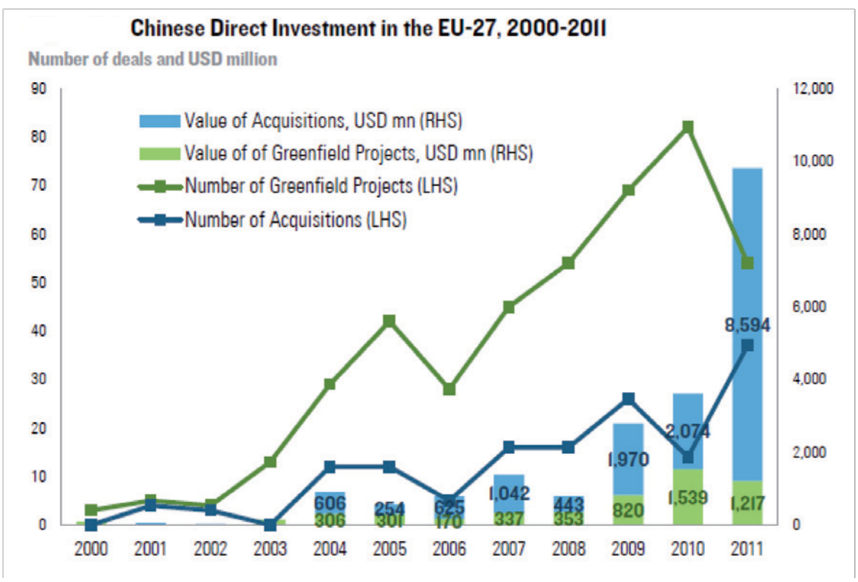


Source: Eurostat

EU-China investment flows



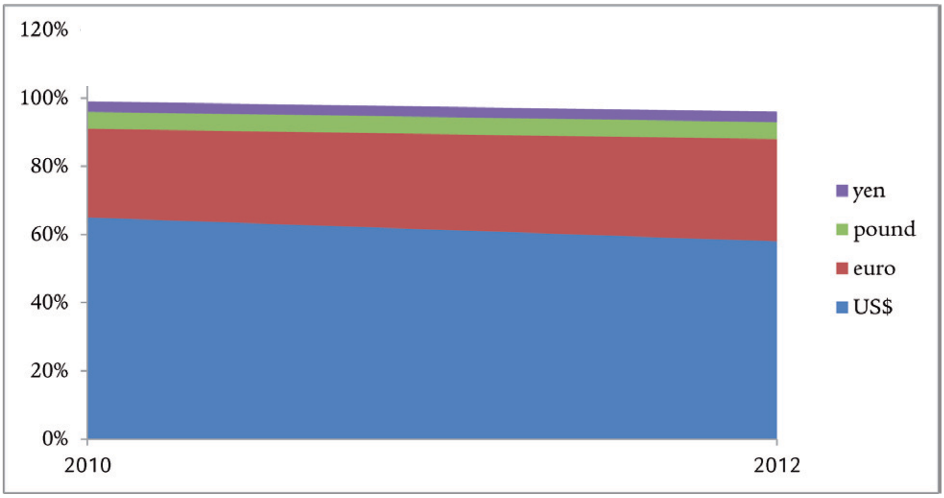
Source: Eurostat; China Ministry of Trade



Source: Thilo Hanemann and Daniel H. Rosen, *China Invests in Europe*, Rhodium Group, 7 June 2012.

China's forex portfolio

	2010	2012
US$	65%	58%
euro	26%	30%
pound	5%	5%
yen	3%	3%



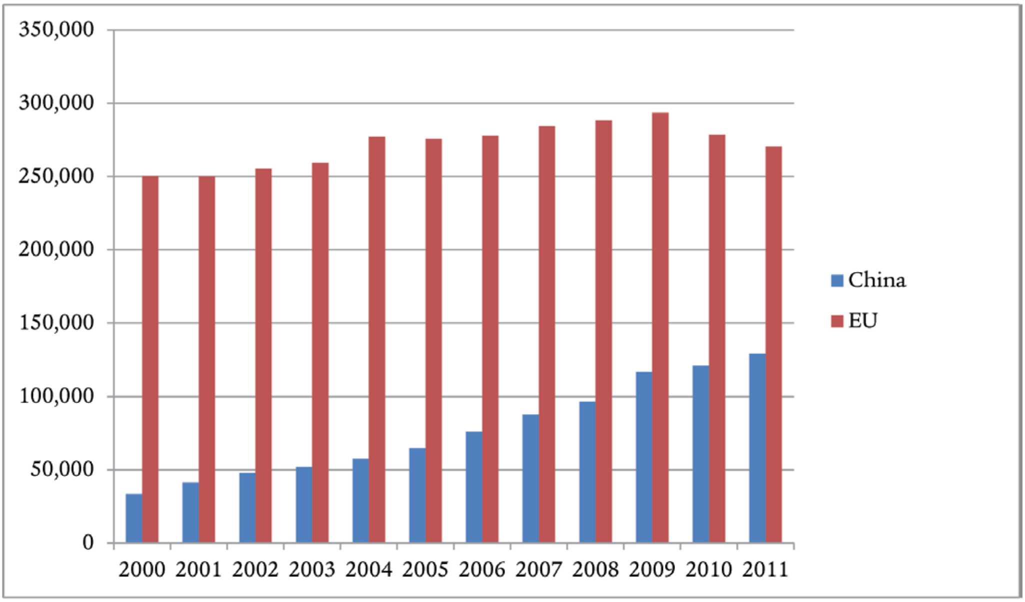
Source: EUISS research; IMF COFER Database

Dollar versus euro holdings

Source: EUISS research; IMF COFER Database

Military expenditure of China and the EU-27 (2000-2011)

in constant US$ billion



Source: EUISS Research; SIPRI

Major flashpoints in North East Asia

Source : EUISS research.

Abbreviations

ADMM+	ASEAN Defence Ministers' Meeting Plus
APEC	Asia Pacific Economic Cooperation
ARF	Asian Regional Forum
ASEAN	Association of South-East Asian Nations
ASEM	Asia-Europe Meeting
BRICS	Brazil, Russia, India, China and South Africa
CCP	Chinese Communist Party
CDM	Clean Development Mechanism
CEO	Chief Executive Officer
CFSP	Common Foreign and Security Policy
COFER	Currency Composition of Official Foreign Exchange Reserves
CSDP	Common Security and Defence Policy
EAS	East Asia Summit
ECB	European Central Bank
ESS	European Security Strategy
ETS	Emissions Trading System
EU NAVFOR	EU Naval Force
FDI	Foreign Direct Investment
FED	Federal Reserve System
FTA	Free Trade Agreement

GDP	Gross Domestic Product
HED	High-Level Economic and Trade Dialogue
IEA	International Energy Agency
IMF	International Monetary Fund
IMS	International Monetary System
IPR	Intellectual Property Rights
M&A	Mergers and Acquisitions
MES	Market Economy Status
NATO	North Atlantic Treaty Organisation
NGO	Non-Governmental Organisation
ODA	Official Development Assistance
ODI	Outward Direct Investment
OECD	Organisation for Economic Cooperation and Development
OFDI	Outward Foreign Direct Investment
OSCE	Organisation for Security and Cooperation in Europe
PBoC	People's Bank of China
PRC	People's Republic of China
RMB	renminbi
SDR	Special Drawing Rights
SOE	State-Owned Enterprises
UNCLOS	United Nations Convention on the Law of the Sea
USD	United States Dollars
WTO	World Trade Organisation

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