View metadata, citation and similar papers at core.ac.uk
brought to you by CORE
provided by Research Papers in Economics

China and India

Europe's Trade Policy with India and China

Peter Mandelson*

Europe's political contact with the civilizations of India and China began with trade. Dutch merchants opened up trade with the coastal Indian states and then China, and the trade that followed fed a growing European fascination with Asian cultures and aesthetics. From India, European merchants brought textiles, ivory and wooden furniture. From the Middle Kingdom, the blue and white porcelain so ubiquitous in seventeenth century Europe that it became known – and is still known – simply as China. Four hundred years ago India and China accounted for half of the world's economic output. They remained the two largest economies in the world until the nineteenth century.

From an historical perspective, the economic rise of India and China looks more like the reassertion of an older and deeper economic order briefly interrupted by the colonial period, Cold War and economic autarky in the twentieth century. From the perspective of a human lifetime – which is the only perspective that matters in politics – it is nevertheless part of a seismic shift in the global economic architecture and one that will have profound political consequences. We live in an economically multipolar world and global politics will soon reflect this much more explicitly.

China's manufacturing economy and – to a much lesser extent – India's services economy are already driving deep and painful economic change in Europe. As the two most salient parts of a rapidly changing global economy, Europe's political response to the rise of China and India is likely to be emblematic of its response to globalization itself.

Alongside the successful completion of the Doha Round and the maintenance of the WTO system, the effective integration of China and India into the global trading system and the establishment of reciprocal access to their growing markets for EU exporters is a key dimension of EU trade policy.

China and India are of course *different*. They have different traditions and political systems. They are following their own paths to development, at their own pace and based on their own distinct economic models. And the EU's policies towards them must be distinct. But these emerging giants represent a third of humanity and their reintegration into the global economy will have huge implications. The EU needs a coherent strategy for responding. What follows is a brief assessment of what I regard as the key political challenges posed by that policy.

EU-China trade relations

China's rise has exerted serious pressure on many European industries, especially in labour intensive manufacturing. This is a painful adjustment for many and it is generating significant political pressures. China is forcing European companies to compete harder both for their own markets and for export markets. To a much greater extent than India, whose 8 percent growth is built largely on growing domestic demand, the Chinese focus on export-led growth has meant a much more assertive posture in European and global markets. India's trade accounts for 1 percent of all trade in goods while China's is closer to 8 percent. The increase in China's trade in 2004 alone was greater than India's total foreign trade. China has just become Europe's largest import partner and runs a sizeable trade surplus with Europe.

The large increase in manufactured exports to Europe from China is chiefly a result of a wider restructuring of export markets in Asia as a whole, either through relocation to China from other parts of Asia or exploitation of China's role as an entrepot. EU imports from Asia have remained stable at 20 to 25 percent of import trade over the last decade. But these nuances are not reflected in the popular

* EU Trade Commissioner.

European assessment of China's strength and competitive challenge. There is a political perception in many parts of Europe that China has grown at Europe's expense.

Nevertheless, on balance the EU benefits much more economically from China's openness and economic strength than it suffers from the increased competition in some sectors. By 2010 the Chinese middle class will number 150 million and its market for high value goods will be worth more than a trillion euros a year. Its markets for key EU exports will be concomitantly large: by 2010 it will be the biggest consumer of wine globally; its market for green technology will be worth 100 billion euros a year and its market for business services 500 billion euros.[1]

European companies have played a significant part in the flow of capital into Chinese production that has resulted in more than half of Chinese export capacity being capitalized by non-Chinese companies. Chinese supply chains allow EU companies to remain competitive by relocating labour intensive production out of Europe while keeping management, design and retail in Europe. The OECD has estimated that cheap goods and inputs from China help depress inflation by 0.2 percent for 2001 to 2005, with a consequent beneficial decline of interest rates. A Dutch study suggested that the average European family saves about 300 euros a year through cheaper Chinese goods; a benefit that is largely skewed towards Europe's poorest consumers. Politicians that advocate large tariff increases for legitimately traded Chinese imports usually ignore the fact that such tariffs would be socially regressive, impacting chiefly on poorer consumers of Chinese-produced clothes, shoes and toys.

These existing and potential benefits are seriously qualified by continued problems with access to the Chinese markets both for exports and investment. This is expressed at the simplest level by the fact that for every four containers leaving Shenzhen in China for Europe, three are still returning empty.

It is true that China is already far ahead of almost all other emerging economies in opening its market to trade, chiefly through the heavy pressure on Chinese tariffs exerted by the WTO accession process in 2001. China's average tariff of 8.8 percent for industrial products is the lowest among the emerging economies, although serious tariff peaks remain in key industrial goods like automobiles, textiles and shoes. Moreover, it is not unreasonable to argue that China's extraordinary export capacity and the fact that it will be the largest exporter in the world by 2010 mean that its political benchmark is not to be found in the developing world. The EU has engaged the WTO's dispute settlement machinery in testing China's continued practice of applying tariffs for whole vehicles to imports of vehicle parts – a practice it explicitly committed to ending on WTO accession.

These unfulfilled commitments extend into the services and investment sectors. China committed to a limited opening of its telecoms sector when it joined the WTO in 2001, but despite having subsequently allocated 16,000 telecoms licenses, only five have been granted to foreign providers. EU companies are still prevented from freely choosing joint venture partners and are often subject to enforced technology transfers through obligatory joint ventures and local content requirements. In investment, China maintains ownership and capital caps of between 20 to 25 percent on foreign investment in the banking sector. Branches of foreign banks in China are subject to discriminatory capitalization requirements relative to local banks. There remains a huge array of non-tariff and regulatory barriers to the Chinese market for EU exporters.

Agreements on patents, data exclusivity and intellectual property rights are also still poorly enforced in China, with serious costs for EU companies operating in the Chinese market. A recent EU study cited an estimate by EU manufacturing industry in China that intellectual property fraud costs EU businesses in China 20 percent of their revenues.

The Chinese government is increasingly recognising the extent to which poor protection of intellectual property is affecting China's own innovation culture – the Chinese film and music industry, for example, is being seriously undermined by local piracy. China's manufacturing sector remains heavily characterised by low levels of value-added production and this is unlikely to change unless Chinese companies have the confidence to invest creative capital. In 2006 China overtook Germany to become the world's fifth biggest filer for patents, but there exists a serious imbalance between legal security and effective

[1] A recent study commissioned by the European Commission set out the benefits on a sector-by-sector basis. For details see http://ec.europa.eu/trade/issues/bilateral/countries/china/pr190207_en.htm

access to enforcement for foreign and domestic companies. This will remain a key focus of EU trade policy in China.

There are other structural trade barrier issues that Europe will continue to urge China to address. The focus on export-led growth rather than domestic consumer demand, and high levels of precautionary saving by Chinese consumers restrains the necessary development of a growing consumer economy and acts as a brake and barrier to others' exports to China which would re-balance trade. China's banking system and financial infrastructure is bending under the strain of rapid development and needs urgent reform.

State intervention in the manufacturing sector in China also remains a persistent problem and this has resulted in a growing number of anti-dumping cases against China. Many of these have touched on consumer durables such as leather shoes and have thus been politically highly sensitive. China's perennial complaints about such trade defence action are disingenuous given the level of state intervention in China and the degree of restraint shown by the European Union. They also tend to obscure both the fact that trade defence measures apply to less than 2 percent of all EU-China trade and that China is also a big user of anti-dumping.

Europe and China are now in the initial stages of negotiating a new trade and investment agreement that will start to address some of these issues. But it seems undeniable that market access in China will remain a key challenge and a key focus of resources for EU trade policy for the foreseeable future.

It is also likely to remain the EU's most heavily politicized trade relationship. The perception that China and Europe do not trade on genuinely reciprocal terms encourages a protectionist response that will only be deflected by more concerted efforts from China to trade fairly and meet its market access obligations. A large and resentful constituency in Europe that has been at the sharp edge of China's exploitation of its comparative advantages in low-cost manufacturing has little patience with economic arguments for the overall economic benefits of openness to China. China is deeply dependent on market access to developed economies, but sometimes appears to be willing to call the bluff of those who argue that that access will ultimately depend on greater reciprocity. That may be a strategic misreading of the strength of protectionist sentiment in Europe and the United States.

Obviously, Europe has its own responsibilities. Europe has no interest in challenging the exercise of legitimate comparative advantage in labour or production costs. Europe for its part must commit to helping China assume full market economy status and offering open and fair access to China's exports, and it must adjust to the tough Chinese competitive challenge. We cannot demand openness from China from behind barriers of our own.

EU-India trade relations

The Indian market has similar potential for Europe, qualified in the same way by serious obstacles to market access. India's growing middle class and booming services sector are obvious assets for EU exports and EU capital.

India invokes none of the anxiety that China does for the simple reason that it remains a small exporter to Europe. Much of its economic impact on Europe has been at the politically less visible level of the services sector. This seems likely to change as India's massive capacity and competitiveness in services – described in books like Thomas Friedman's and Clyde Prestowitz's – is brought to bear on the IT and IT support sector in Europe and the US. India is also an increasingly active investor in Europe. Since 2000, Indian companies have invested more than $10 billion in Europe – a fivefold increase in the last decade. Indian firms like Infosys, TCS, HCL, Wipro and Birlasoft have all made impressive inroads into the EU market, of which the Mittal Steel bid for Arcelor was only the most dramatic example – not least because of the unjustifiable defensiveness it provoked in Europe.

Yet this data is chiefly striking in the extent to which it suggests untapped potential. India still accounts for only 1.5 percent of world services trade and 1 percent of global merchandise trade despite the fact that Indians make up one sixth of the world's population.

Europe's exports to India are hardly negligible but they account for less than 2 percent of our goods trade and less than 2 percent of EU outward FDI flows, which is totally out of proportion to India's population and the size of its market. In 2003,

European FDI into India's was just under 4 billion euros whilst China's was 47 billion euros. 1 percent of global foreign investment goes to India and 15 percent to China.

India's historically high tariffs have been coming down through unilateral reform. Its average applied industrial tariff of around 15 percent is exceptional for an emerging economy, but it is still twice that of China and average bound tariff rates are twice as high. Border protection is sometimes discriminatory, an issue the EU has recently raised in its WTO consultations over Indian duties on EU wines and spirits, which at 500 percent are some of the highest in the world.

The days of the "licence raj" are certainly over. But India often remains a difficult place for EU companies to invest and trade. It still takes 89 days on average to start a business in India, more than twice the time in China. Resolving insolvency takes on average ten years in India, four times the equivalent time in China. The IMF's trade restrictiveness index gives India a score of 8 – where 10 is the most restrictive – and China 5. European companies complain of highly restrictive red tape and discriminatory regulation.

The decision to launch an FTA between the EU and India will help reduce many of these barriers. India has an active interest in encouraging European investment that can be an important source of capital for India, not least for the infrastructure work that the Indian government has made a central strand of improving its competitiveness. The aim is to liberalize not just goods and services trade, but to remove non-tariff barriers and establish new rules on issues such as investment, competition and public procurement. That means going beyond WTO rules into areas of mutual interest not yet ready for multilateral agreement at the WTO.

Systemic aspects

These bilateral aspects of Europe's trade policy with China and India are only part of the wider political challenge of integrating China and India into the global trading system. China will soon be the largest exporter in the WTO, and ultimately the largest economy in the global trading system. India will not be far behind. The idea that the rules-based WTO system can function effectively without these two huge powers at its heart is fanciful. Their joint leadership and example both among emerging economies and developing countries will be decisive in reassuring the developing world that the multilateral trading system and progressive trade liberalization can reflect their interests.

Equally important will be the acceptance by both China and India that their growing power creates a growing obligation to open their markets, not least to other developing countries. South-south trade remains the most heavily obstructed trade in the global economy. With tariffs at historically low levels in the developed world, the future of tariff liberalization lies largely in the developing world.

Behind the anxiety of many developing countries in Asia, Africa and Latin America to commit to trade liberalization is fear of the export power of China in particular. Because the growing markets of China and India are as attractive to the manufacturers of the developing world as they are to those of Europe – even more so for the low cost manufactures purchased by China and India's growing cohort of middle and low income consumers – improved market access is the only way to balance that fear.

A successful conclusion to the Doha Round would be a powerful signal and an important step in this respect. Not only would it cement the principle of reciprocal liberalization for the emerging economies but it would open the markets of these economies further to the developing world. If Doha fails, a similar opportunity is not likely to recur in the foreseeable future.

Conclusion

It's easy to forget from a detached or analytical position that the impact of the economic rise of China and India is as much a political issue as an economic one. Assuming that we are able to dismantle barriers to access in China and India, both bilaterally and through the multilateral system, Europe stands to gain hugely from the economic strength of both – as a source of cheap inputs, as a market for exports and as a destination and source of investment in liquidity-rich global capital markets. But both are exploiting comparative advantages in the global economy that are – or are likely to – exert serious pressure on some sectors of the European economy.

Convincing our own constituencies that the wider benefits of this economic pressure outweigh the costs in isolated sectors is part of Europe's wider challenges of adaptation to a globalized economy. It means a concerted public policy response in Europe to address the needs of those faced with the impact of economic change and adaptation. But it also requires the clear demonstration of reciprocity from India and China. EU trade policy is the means both of delivering that reciprocity and securing the European openness that legitimizes the demands we make of others.

Obviously, Europe's relations with both China and India go much beyond trade. China and India will be central to the global response to climate change. They will be central to the geopolitics of energy supply. They are both nuclear powers in neighborhoods with potential for instability. Yet ordinary Europeans' first confrontation with India and China is likely to be as economic powers, changing the shape of our economic world. That fact alone means that the management of trade politics will be at the centre of our relationship.