EU-China: Towards a Strategic Relationship

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Introduction

- A strategic relationship between the EU and China must be based on long-term considerations and must be win-win for both sides to be viable. There are great opportunities for such a strategic relationship, for a deeper economic cooperation.
- The new opportunities in the Chinese market for European Union countries are in both consumer good and services, catering to the rapidly growing middle class, and in manufacturing equipment and technologies, supplying the "Made in China 2025" efforts.
- In addition, China needs to invest its surplus savings overseas and also to diversify its wealth. Europe is a leading destination for Chinese outbound investment, both direct and portfolio. This can be win-win for both economies.
- How to use China's surplus savings to the benefits of both China and the European Union?

Introduction

- The GDP of the European Union was €14.6 trillion (US$15.9 trillion) in 2015, representing 21.7 percent of the world economy. It is smaller than the U.S. GDP of US$17.9 trillion, but larger than the Chinese GDP of US$10.4 trillion.
- The population of the EU was 509 million in 2015 compared to China's 1.37 billion.
- The GDP per capita of the EU was approximately €28,700 (US$31,246) in 2015, compared to €51,242 (US$55,787) for the U.S. and €6,966 (US$7,584) for China.
- China and EU together is a market of 1.88 billion people with a GDP of €24.1 trillion (US$26.3 trillion), or 36% of world GDP, the largest in the world.

Introduction

- The EU, with a total international trade in goods and services of €12.5 trillion (US$13.6 trillion) in 2015, is the largest trading economy in the world, followed by the U.S., with €4.6 trillion (US$5.0 trillion) and China, with €4.3 trillion (US$4.7 trillion),
- China and EU together is an international trade powerhouse, with a total value of trade of €16.8 trillion (US$18.7 trillion), more than two-thirds of total world trade, the largest in the world. Together, they can try to refine as well as redefine the rules of world trade.
- China is the EU's third largest export market, with 8.5%, after the U.S. (16.5%) and Switzerland (9.7%), but has the greatest potential to grow. The EU is China's largest export market, followed by the U.S.
- China is the EU's most important source of imports, with 16.6%, after Russia (12.2%) and the U.S. (11.6%).

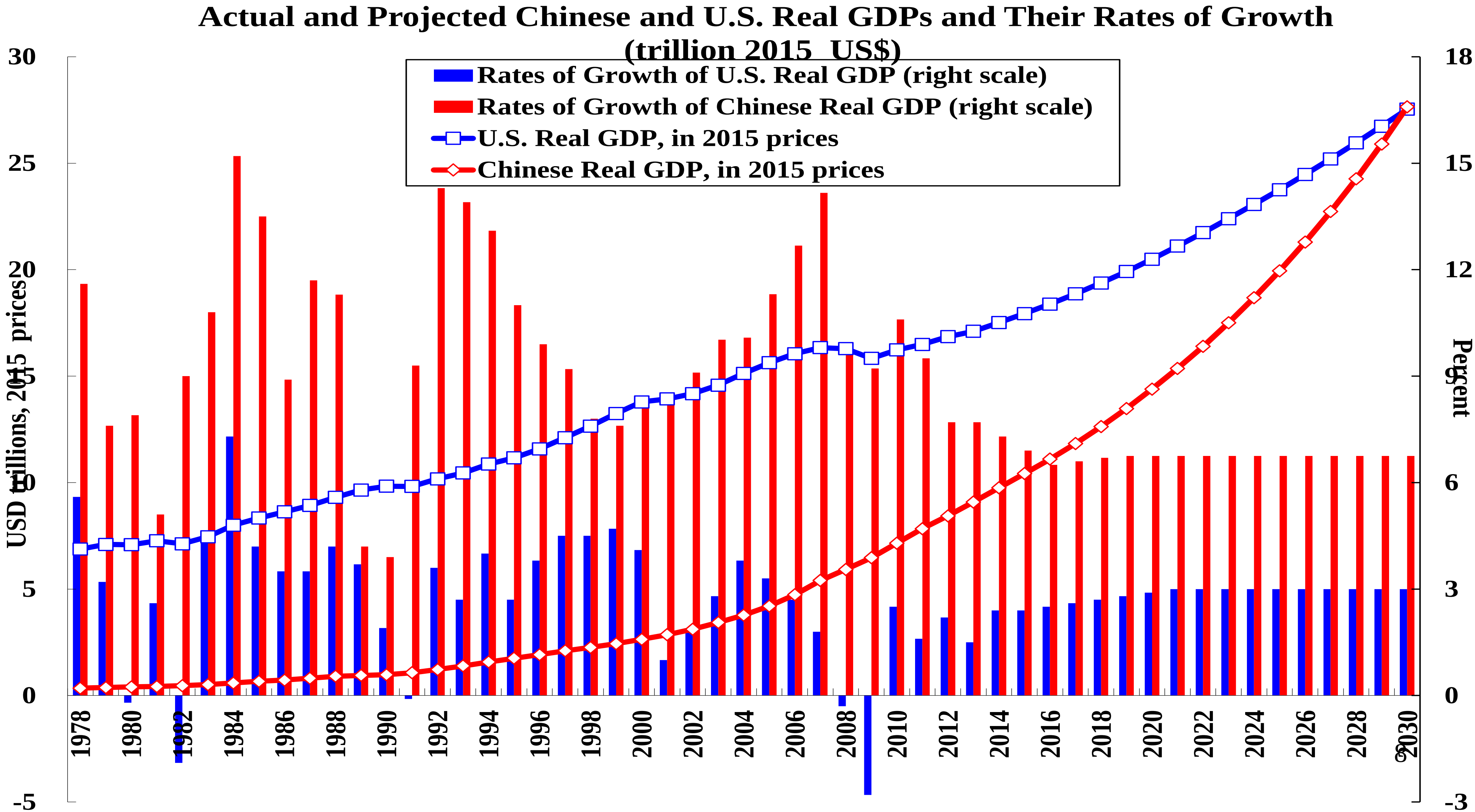
Introduction

- EU-China Free Trade Area and EU-China Bilateral Investment Treaty will be helpful, but some form of mutual exchange rate coordination can help both the economies of both EU and China even more.
- EU and China can cooperate to make the Paris accord on climate change a reality. They can jointly help to provide a global public good.
- EU and China can launch joint EU-China infrastructural projects in Europe and elsewhere.
- EU and China can also engage in scientific and technological cooperation beneficial to both sides as well as to the world.

Long-Term Prospects of the Chinese Economy: Projection of Real GDP to 2030

- It is projected that the Chinese economy will be able to continue to grow at an average annual rate between 6% and 6.5%, and that the U.S. economy will be able to grow at an average annual rate of 3%, between now and 2030.
- At these rates, Chinese GDP will catch up with U.S. GDP around 2030. Based on current exchange rates, Chinese GDP will also catch up with the EU GDP some time before 2030.

The Actual and Projected Level and Annual Rate of Growth of Chinese and U. S. Real GDP



Deeper Economic Cooperation: The EU-China Free Trade Area

- A free trade agreement between the EU and China will be greatly beneficial to both.
- The rapid growth of the middle-class in China implies continued growth of demand for consumer goods and services. The real retail sales of China has been growing at approximately one and a half times the rate of growth of real GDP.
- BMW, Chanel, Ferrari, Hermes, LV, Mercedes Benz and Volkswagen are household names in China.
- Disney just opened in Shanghai, but there is no reason why Babar, Rin-Tin-Tin and Hans Christian Anderson cannot become as popular as Mickey Mouse in China.

Deeper Economic Cooperation: The EU-China Free Trade Area

- The "One-Belt, One Road" initiative of China can also facilitate the growth of trade between China and the EU, especially in terms of a Maritime Silk Road (including the Northern Passage) and the Eurasian Land Bridge. It should not be regarded as a purely geo-political move. It will also greatly help the development of the Chinese West.
- Growth in EU-China trade may help to accelerate the realization of the Eurasian Land Bridge. For example, if department stores in Europe and automobile dealers in China can be re-supplied in seven days, the entire pattern and process of trade will be radically changed, greatly lowering the total transactions costs, including the interest and stocking costs, even though the transportation costs per se may be higher.

Deeper Economic Cooperation: The EU-China Free Trade Area

- Agriculture is another potential area of growth for EU-China trade. China is the world's largest importer of agricultural commodities. China shares the EU's concerns on genetic modification of agricultural crops. Agricultural exports from the EU to China can grow further if questions of long-term reliability and security can be resolved.
- China can also substitute the imports of the final product, e.g., meat, for the imports of feeds. There should be significant Chinese demands for wheat, pork and dairy products.
- There is considerable room to introduce new production in the EU to support long-term (say 20 years) cost-plus export contracts of food products to China.
- However, Chinese farmers need to be convinced that this is not a threat to their livelihood.

Deeper Economic Cooperation: Bilateral Investment Treaty

- A bilateral investment treaty (BIT) between the EU and China will be extremely useful, especially now that Chinese enterprises are beginning to make direct investments overseas.
- The basis should be "national treatment" plus a "negative list", which can be different between EU and China.
- In addition to the mutual protection of each other's investment in the other economy, the treaty can and should also provide for the possibility of 100% ownership, except in certain specified industries, such as telecommunication and airlines.
- Infrastructural investment should also be included in the BIT, whether directly, or indirectly in the form of portfolio investment, e.g., the purchase of bonds of infrastructural projects. China will have net surplus savings for at least a decade or even longer.

Deeper Economic Cooperation: Bilateral Investment Treaty

- For example, a Chinese enterprise can cooperate with an European firm, for example, Siemens, to build a high-speed railroad linking Istanbul to Berlin and ultimately to Paris (A new "Orient Express"). Such a project can be financed by project bonds sold to Chinese and other institutions.
- One alternative approach to mergers and acquisitions between enterprises in the EU and China is to introduce a form of joint or cross-ownership. For example, hypothetically, the Volkswagen joint venture in China can be injected into Volkswagen so that it becomes a wholly-owned subsidiary of Volkswagen, in return for Chinese equity ownership in Volkswagen of a certain percentage, say 20%, with the shares of Volkswagen listed in both Frankfurt and Shanghai (and possibly elsewhere). This can align the interests of everyone. (This form would have some resemblance to Royal Dutch Shell, which is a joint Netherlands-U.K. company.)

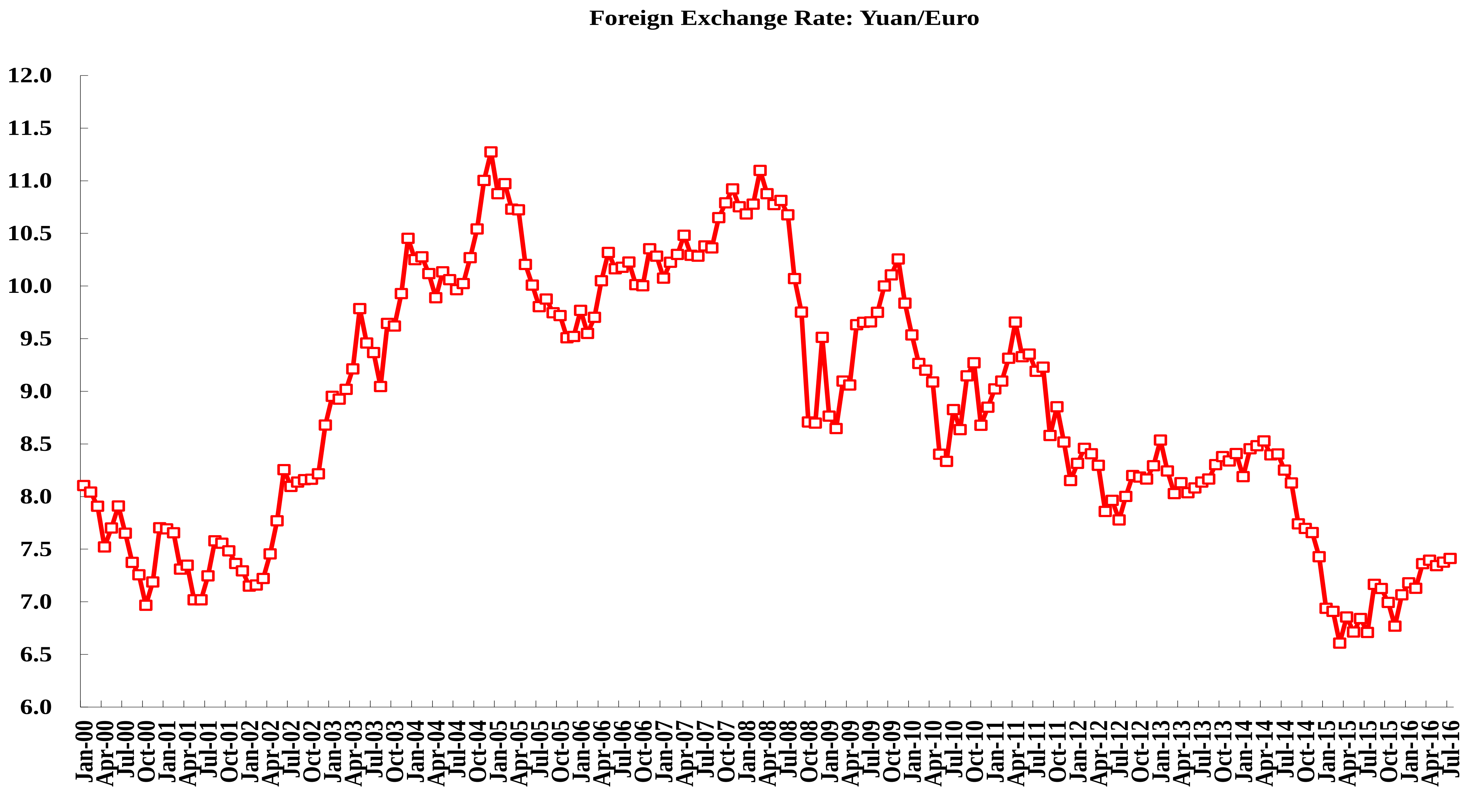
Deeper Economic Cooperation: Bilateral Investment Treaty

- The “Made in China 2025“ plan recently announced by the State Council of China is designed to improve Chinese capability in manufacturing to a level comparable to Germany (and Japan) today.
- The 10 key sectors that are the foci of “Made in China 2025“ plan are new information technology, numerical control tools and robotics, aerospace equipment, ocean engineering equipment and high-tech ships, railway equipment, energy saving and new energy vehicles, power equipment, new materials, biological medicine and medical devices, and agricultural machinery.
- This will provide opportunities for EU firms to take stakes in Chinese enterprises as well as to invite Chinese enterprises to take equity interests in EU firms.
- EU firms will also be able to supply the advanced equipment and technology needed,

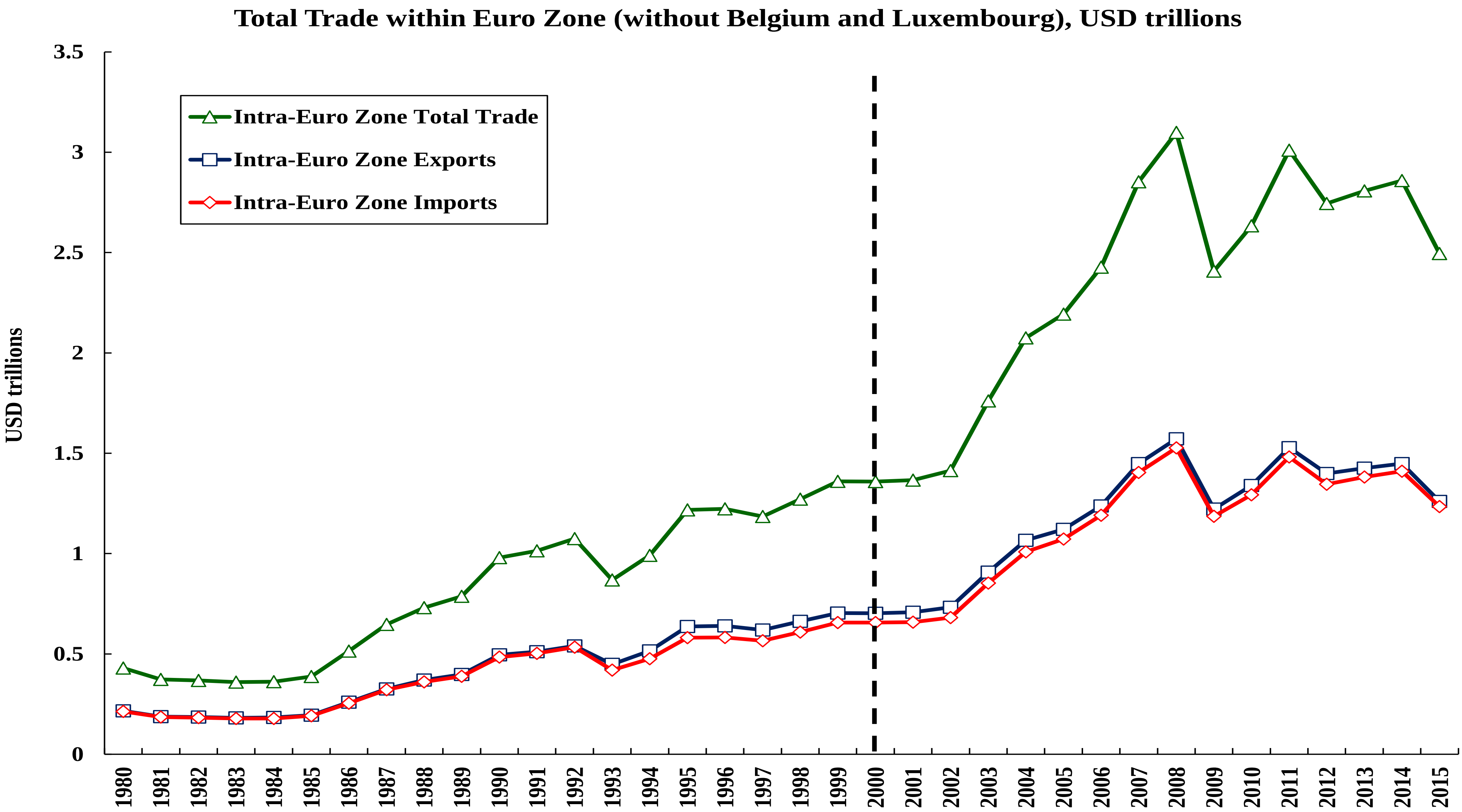
Deeper Economic Cooperation: Exchange Rate Coordination

- A EU-China Free Trade Area will certainly increase trade between the two economies. Similarly, a EU-China Bilateral Investment Treaty will increase direct investment in both directions.
- However, expectations of future uncertainty and volatility of the Euro-Yuan exchange rate tend to discourage the growth of both trade and direct investment; whereas a relatively stable Euro-Yuan exchange rate will facilitate their growth.
- The experience of the rapid growth of intra-Euro Area international trade after the introduction of the Euro in 2000 is testimony to the large and positive effect of a reduction in the volatility and uncertainty of relative exchange rates on international trade.
- Since 2000, the Euro-Yuan exchange rate has fluctuated between a high of almost 11.5 Yuan/Euro in 2004 to a low of almost 6.5 Yuan/Euro in 2015. This is a huge range. More recently, the exchange rate has stabilized around approximately 7.5 Yuan/Euro.

The Yuan/Euro Exchange Rate



Intra-Euro Area Trade, Billions Euro, Pre-and Post the Introduction of the Euro



Deeper Economic Cooperation: Exchange Rate Coordination

- A proposal has been made by Prof. Robert A. Mundell, Nobel Laureate in Economic Sciences, sometimes referred to as the Father of the Euro, for the efficient and incentive-compatible mutual exchange rate coordination between two trading partners.
- Basically the idea is for the two trading partners to agree on a range of fluctuation for their relative exchange rate, say 5% up or down from an initial central rate.
- Take for example, China and the EU. When the Euro is too strong and threatens to exceed the upper limit of the band, the European Central Bank (the Euro Area central bank) will buy Renminbi with Euros, driving up the Renminbi exchange rate relative to the Euro. When the Euro is too weak and threatens to breach the lower limit of the band, the People's Bank of China will buy Euros with Renminbi, driving up the Euro exchange rate relative to the Yuan.
- Such an arrangement will stabilize expectations of the Yuan/Euro exchange rate for exporters, importers and direct investors in both the EU and China. The enforcement mechanism is incentive-compatible as both economies will try to prevent their exporters from being too disadvantaged. It will also discourage short-term speculators by limiting their potential gains.

Deeper Economic Cooperation: Exchange Rate Coordination

- The timing for the introduction of exchange rate coordination between China and the EU is right as the Euro is near its historic low relative to the Yuan. For example, one can set the range of fluctuation of the relative exchange rate to between 7 Yuan/Euro and 8 Yuan/Euro (a range slightly more than 10% of the current exchange rate).
- With such an agreement in place, the use of the Euro and the Renminbi as an invoicing, clearing and settlement currency in international transactions is likely to increase because of their relative stability. The Euro and the Yuan are also likely to move up and down vis-a-vis the U.S. Dollar together. However, this is not a fixed peg between the Euro and the Yuan.
- A successful mutual exchange rate coordination essentially provides exporters, importers and direct investors in both economies with a free long-term exchange rate hedge which are not normally available on the market.
- If the Euro (and the Yuan) are used more often as an international medium of exchange and an international store of value, there is seigneurage to be earned.

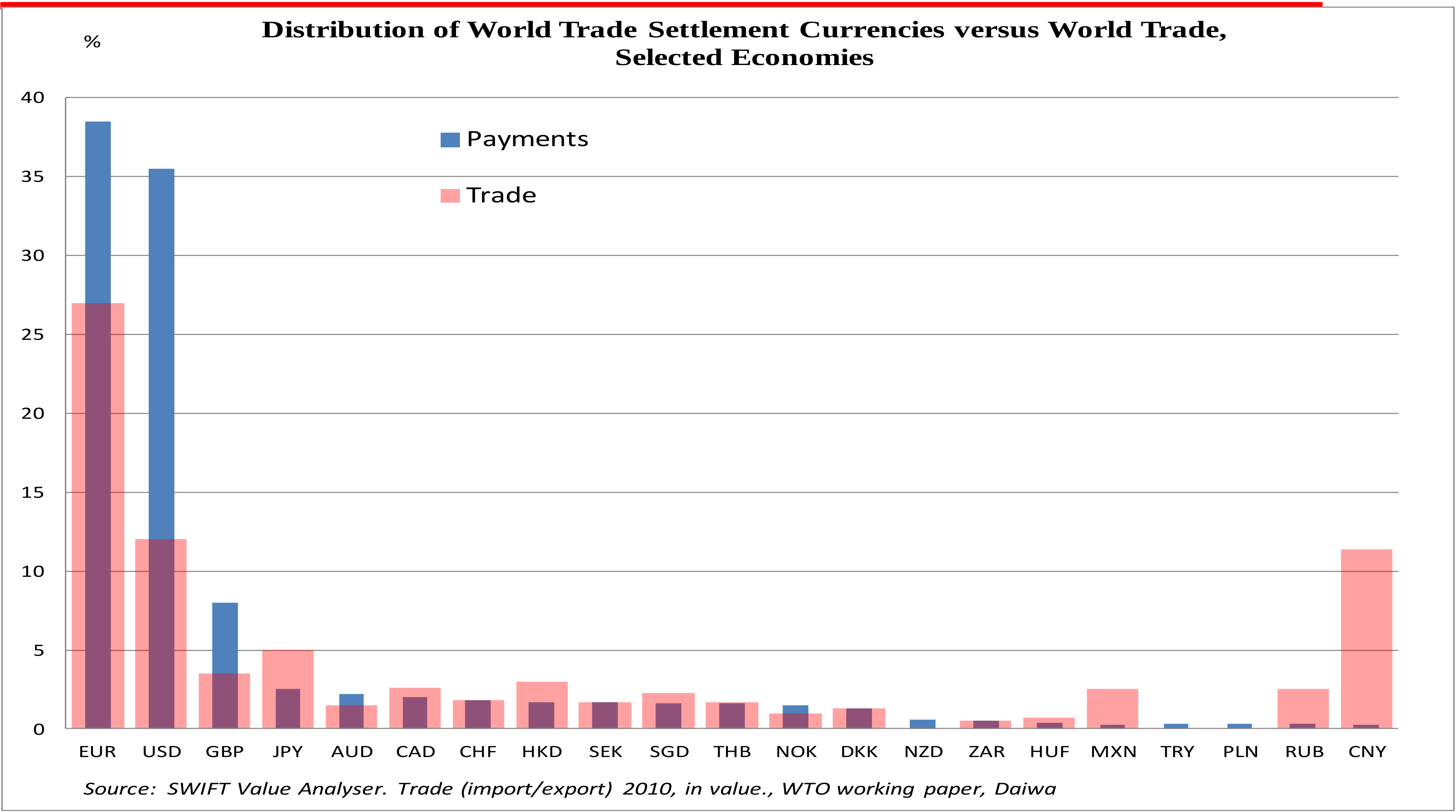
Currency Competition and Substitution

- It is useful to examine the change over time of the use of different currencies in the settlement of world payments. In the charts that follow, the shares of the top twenty currencies used in world settlement at selected dates between 2010 and 2016 are presented in the order of their relative sizesfrom left to right, starting from the highest (using data from SWIFT), and compared to the shares of the respective country or region in world trade.
- An economy’s share of world trade is an important, but not the only, determinant of whether its currency is widely used as a medium of international exchange. Every economy prefers to use its own currency for the settlement of its international transactions because it minimizes both risks and transactions costs.

Currency Competition and Substitution

- In 2010, before the European sovereign debt crisis broke out, the Euro was the most widely used currency for invoicing, clearing and settlement purposes, accounting for almost 40% of the total world payments, but only a little more than 25% of total world trade. The U.S. Dollar was a close second, accounting for a little over 35% of world payments but only slightly more than 10% of world trade. The British Pound was third, accounting for not quite 9% of the world payments and 3% of world trade. The Renminbi was in the 21st place in terms of its share of total world payments despite its more than 10 percent share in world trade.

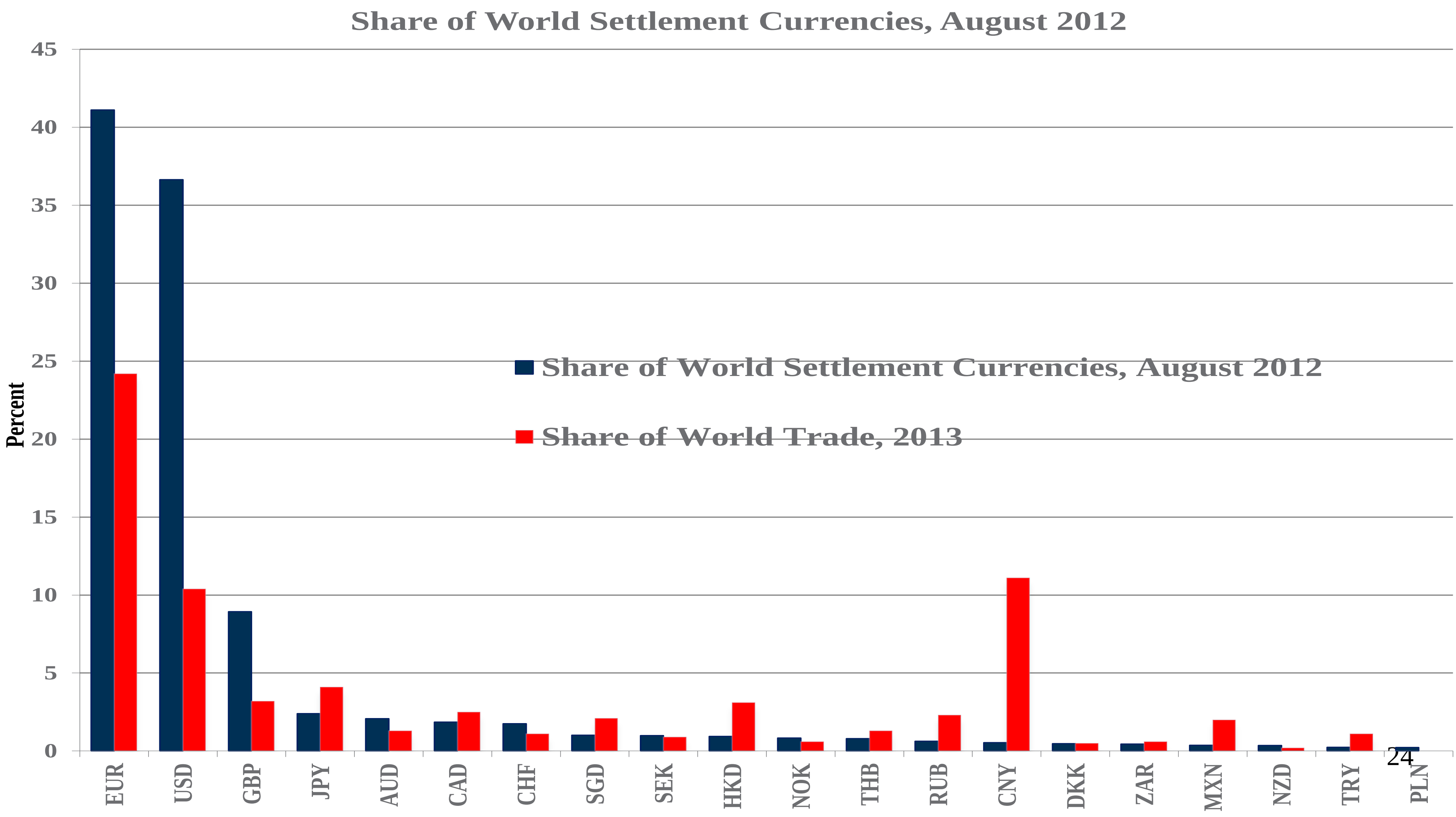
Distribution of World Trade Settlement Currencies versus World Trade, 2010



Currency Competition and Substitution

- By August 2012, the share of the Euro in world settlement remained in the first place, just above 41.1%, despite the European sovereign debt crisis. The share of the U.S. Dollar rose to 36.6%. The Renminbi just climbed to the 14^{th} place in world payments despite the fact that China's share of world trade was more than 10%, more than anyone else except for the Euro Area and the U.S.

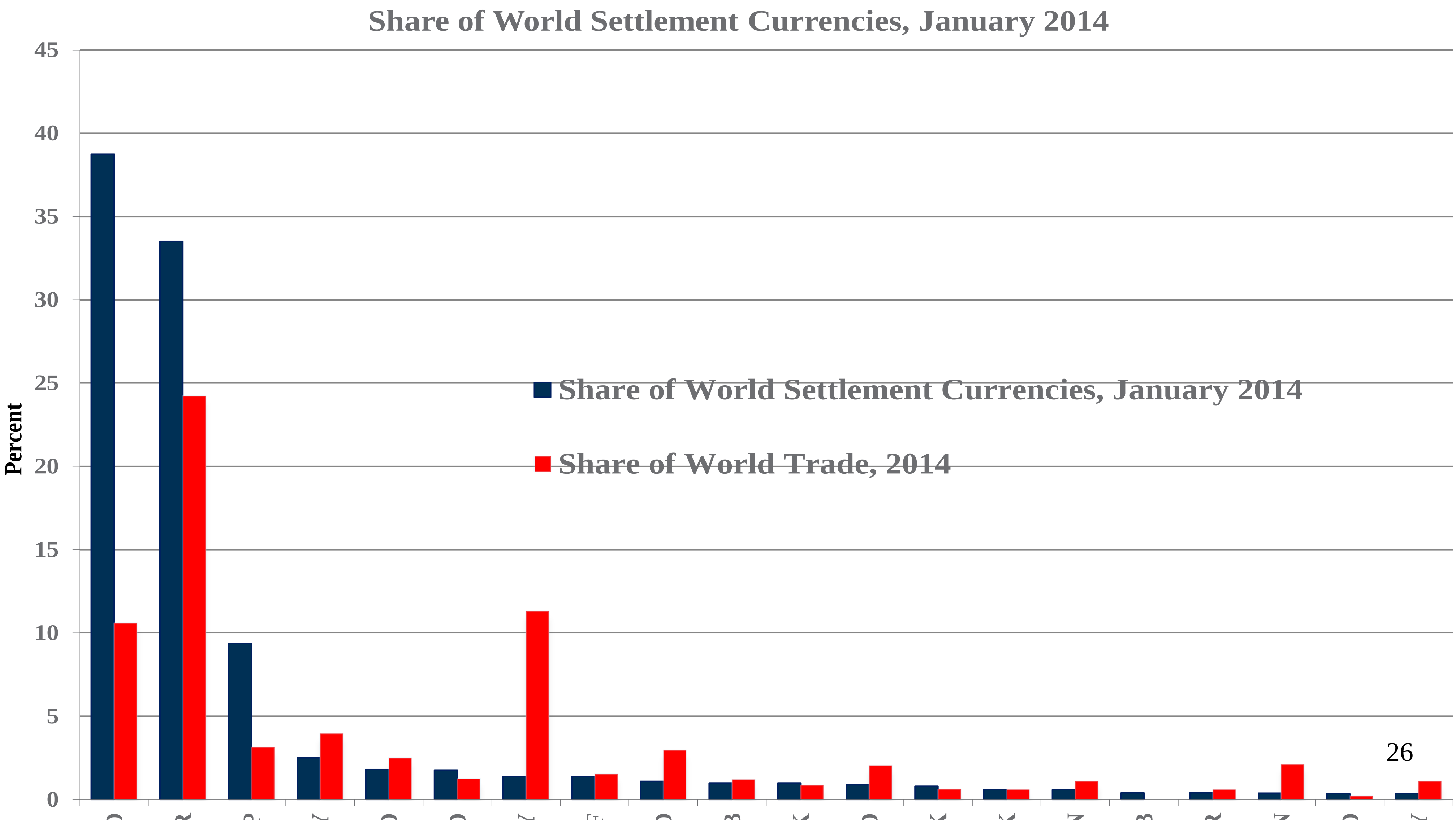
Distribution of World Trade Settlement Currencies versus World Trade, August 2012



Currency Competition and Substitution

- By January 2014, the U.S. Dollar overtook the Euro as the leading world settlement currency, with 38.8% versus 33.5%. In the meantime, the Renminbi advanced to the seventh place in terms of its share in world payments.

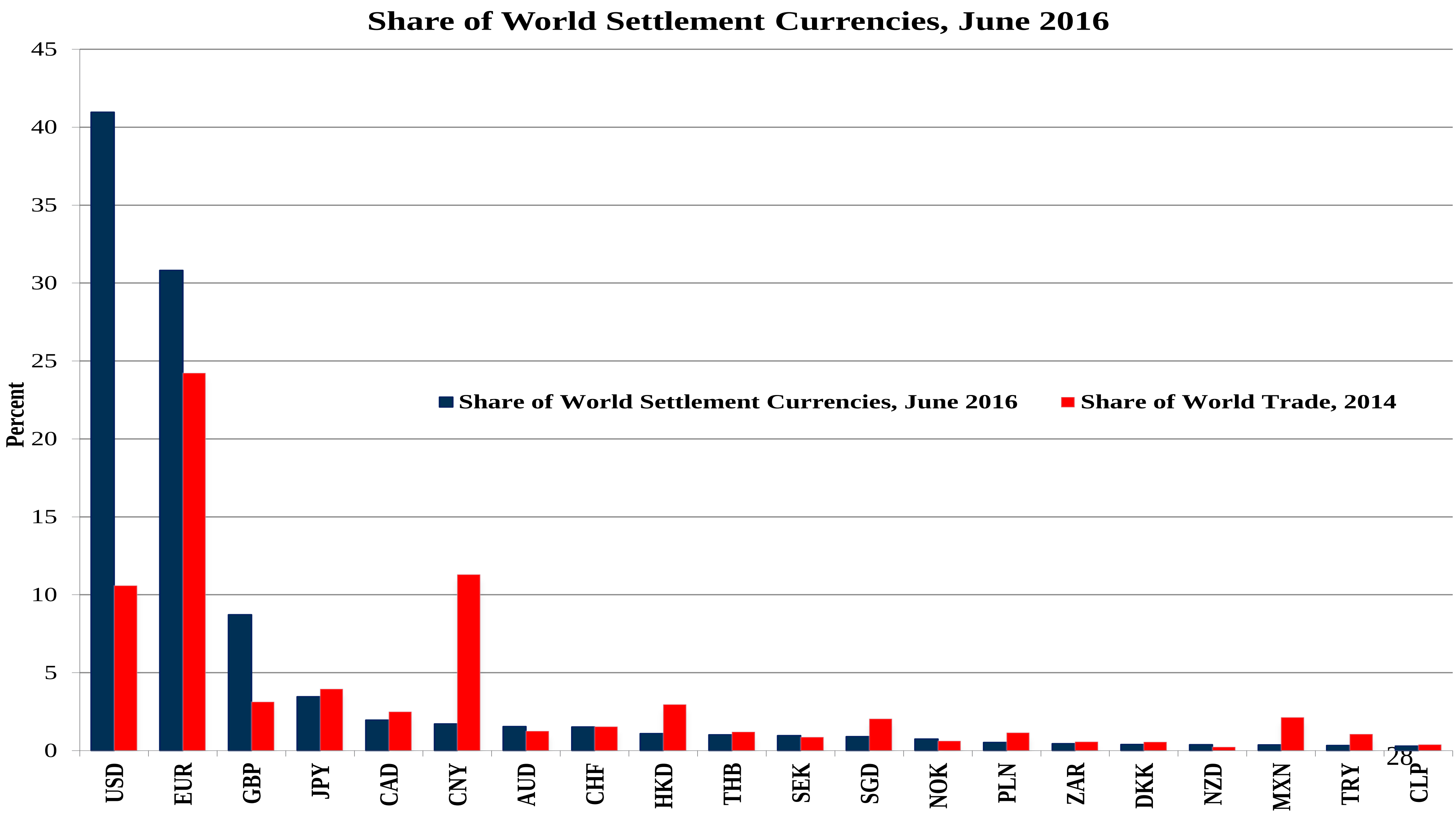
Distribution of World Trade Settlement Currencies versus World Trade, January 2014



Currency Competition and Substitution

- By June 2016, the U.S. Dollar accounted for 41% of world payments compared to the Euro's 31%.
- While the Renminbi did advance to the fifth place in terms of its share in world payments in 2015, it fell back to the sixth place in June 2016, behind the U.S. Dollar, the Euro, the British Pound, the Japanese Yen and the Canadian Dollar, and accounting for only 1.7% of world payments.

Distribution of World Trade Settlement Currencies versus World Trade, June 2016



Prevention of Climate Change

- The Chinese Government is strongly committed to the prevention of climate change. In its Thirteenth Five-Year (2016-2020) Plan, there are only two sets of mandatory targets. One has to do with the elimination of poverty and the other has to do with improving energy efficiency, reducing carbon emissions and cleaning up the environment in general.
- The EU has always been in the vanguard for energy conservation and the prevention of climate change. There can be many opportunities for cooperation, for example, in the sharing of environmental technologies and joint R&D. China can learn a great deal from the European experience on the efficient heating and cooling of buildings (e.g., triple glazing, utilizing the excess manufacturing capacity in the flat glass industry in China, and solar power).

Prevention of Isolationism and Protectionism: A Universal Import Tax

- Free trade and globalization have been identified as the major causes of many social ills around the world, especially by populist politicians.
- While voluntary trade between two trading partner countries always increases the aggregate welfare of each of the countries, and globalization has brought huge benefits to the world and lifted hundreds of millions of people out of poverty, they have, however, created both winners and losers in every economy.
- For example, the exporters will obviously benefit from free trade and globalization. So will the consumers of imported goods. However, the firms which produced products that are replaced by imports, and their workers, will be the losers. Out-sourcing of services, which reduces domestic employment, also creates losers.

Prevention of Isolationism and Protectionism: A Universal Import Tax

- Moreover, globalization also implies that the wage rate of unskilled entry-level labor will fall to the level of the lowest unskilled entry-level wage rate in the world (through factor-price equalization) in the absence of transportation costs. In the presence of transportation costs, the outcome will be similar—there will be a fall in the unskilled entry-level wage rate in the country with the initially higher wage rate.

Prevention of Isolationism and Protectionism: A Universal Import Tax

- One vexing problem of long standing for governments worldwide is how to re-distribute the gains from international trade among their citizens so that everyone, or almost everyone, can receive a net benefit. Too little is done systematically for the workers displaced by imports, which accounts for the relatively widespread opposition to globalization and free trade agreements.
- Unless the “losers” can feel that they have also benefit from international trade, they will oppose the expansion of trade and further opening of the economy. The losers from trade must be adequately compensated and provided with the necessary training so that they can be re-employed in other jobs.

Prevention of Isolationism and Protectionism: A Universal Import Tax

- What is needed is a mechanism for the creation of revenue that can be used for the compensation of the losers from international trade. One major class of beneficiaries from imports are the consumers of the imported goods (and services), hence a universal import tax is proposed so that the beneficiaries themselves bear the burden of compensation.
- For example, one can introduce a uniform import tax of say 0.5% that is levied on all imports of goods (and perhaps also services) from all countries, with the proceeds to be used for the term support and re-training of workers displaced or otherwise harmed by imports. Such displacement is not cyclical and hence is beyond the scope of traditional unemployment insurance.
- If all countries agree to adopt the uniform import tax, it is not distortive.

Prevention of Isolationism and Protectionism: A Universal Import Tax

- Moreover, since exporters are also a major class of beneficiaries from international trade, one can also introduce an universal export tax of a similar magnitude. This means all the beneficiaries from international trade, the exporters and the importers, will contribute part of their gains in the form of taxes to their respective governments so that the losers within their respective countries can be compensated.
- But even if exports are not taxed directly, the burden of the import tax is also shared by the exporters in the exporting country indirectly. So it may not b necessary to have a separate universal export tax.

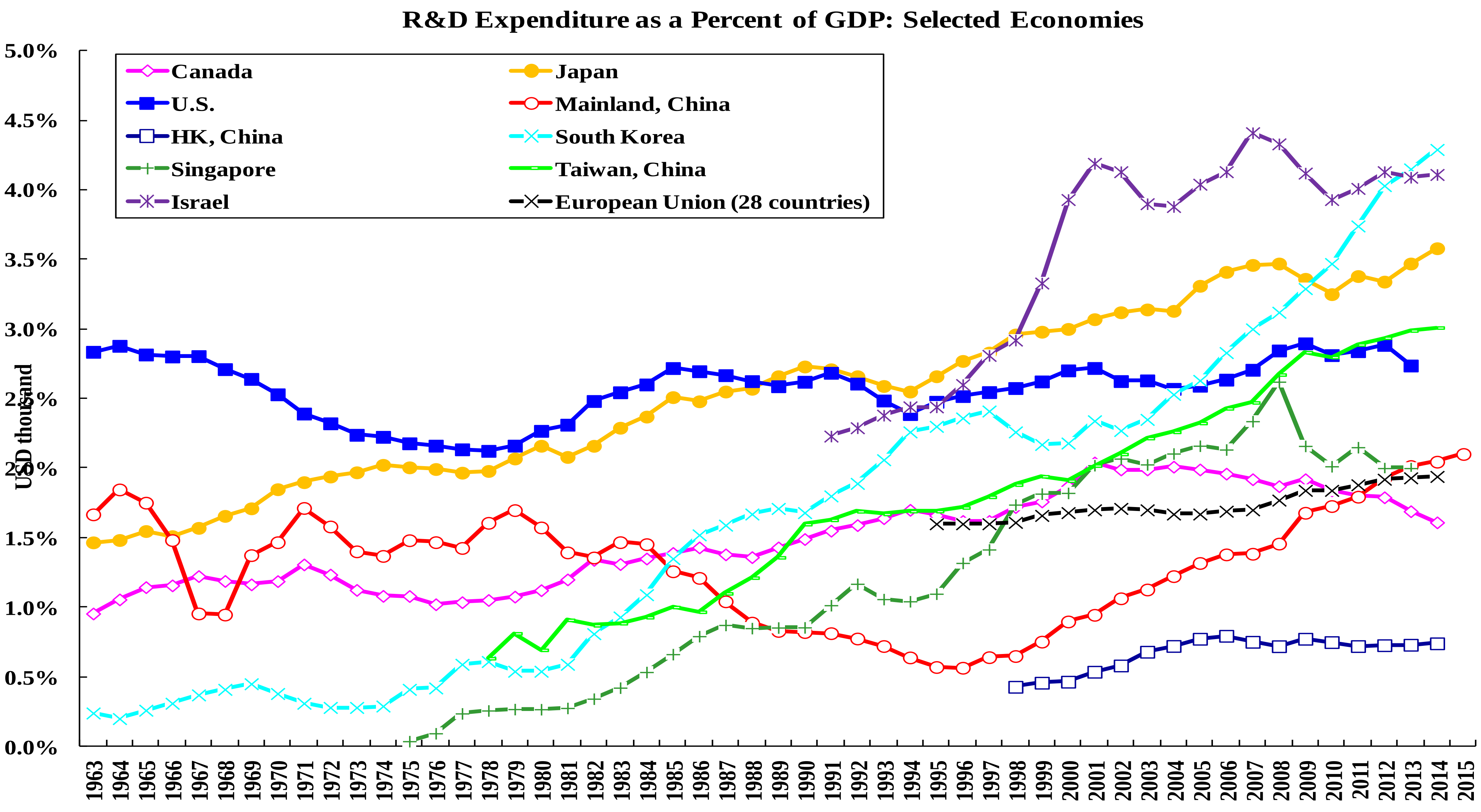
Prevention of Isolationism and Protectionism: A Universal Import Tax

- The EU and China can, within the context of a EU-China Free Trade Area, bilaterally and voluntarily agree to levy a uniform import tax of say 0.5% on the imports from each other, with the proceeds used to assist the workers displaced or harmed by imports.
- Since the import tax is voluntarily agreed by both trading partners, the World Trade Organisation (WTO) should not object. The other economies would not object either, because they would enjoy a slight price advantage (of 0.5% in this example) in exporting to the EU and China.
- Of course, ultimately, it is hoped that all the WTO members (at least all the major trading countries) will adopt the universal import tax because they all face the same domestic problem of having to compensate the losers from international trade. But EU and China together already account for more than two-thirds of world trade and can have a significant influence in making the uniform import tax truly universal if they can agree to act in concert.

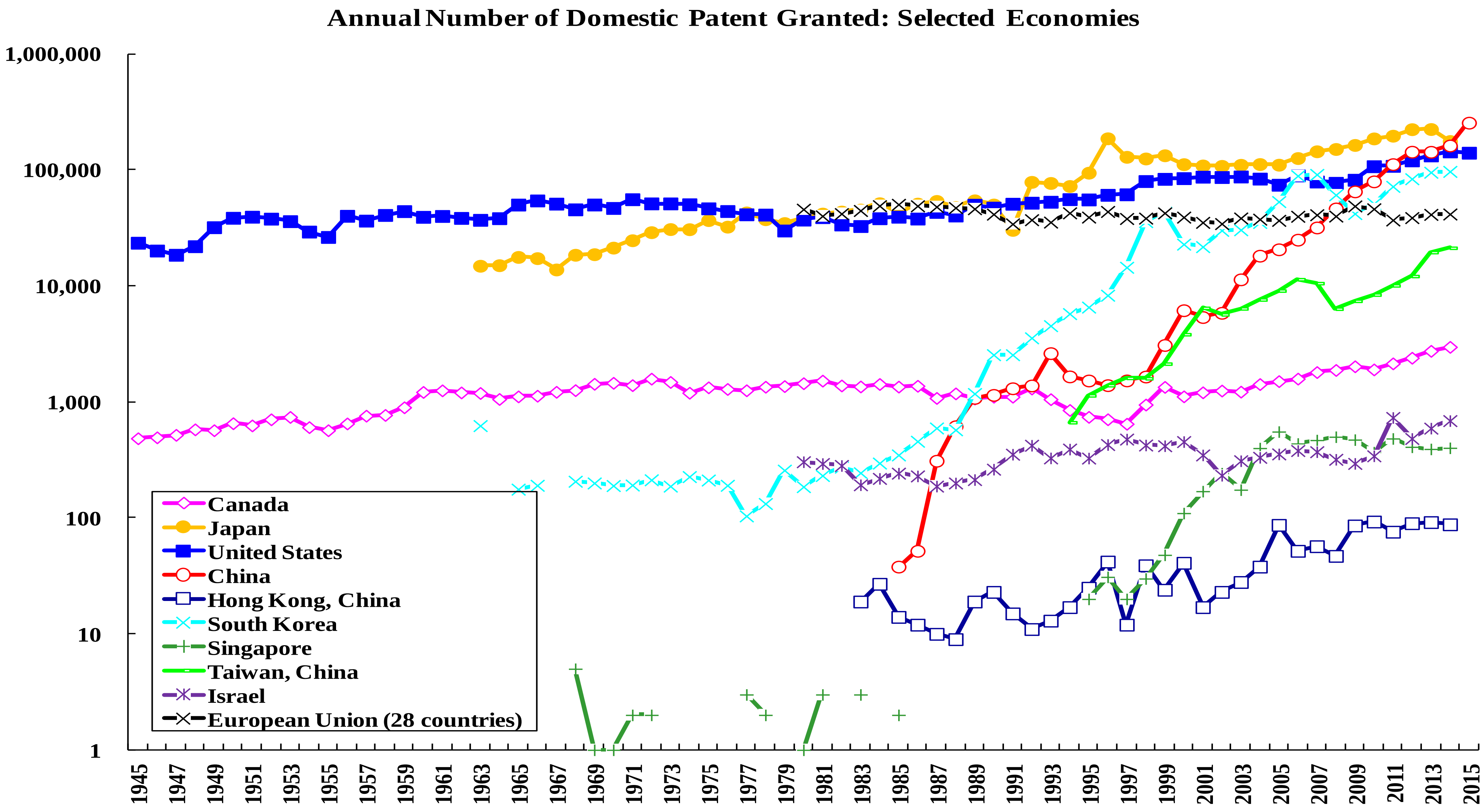
Scientific and Technological Cooperation: Intellectual Property Protection

- Both the EU and China have large and increasing numbers of domestic patents. The annual number of domestic patents granted in China has exceeded that of the EU within the last year or so.
- The EU and China also have potentially very large and profitable markets for the exploitation of these patents.
- Intellectual property protection has been significantly strengthened in China. China has established special national intellectual property courts in Beijing, Shanghai and Guangzhou to deal exclusively with such cases.
- The EU and China may wish to consider ways to facilitate the applications by applicants from either economy for patents in the other by recognizing the working papers used in their domestic patent applications. This does not imply reciprocal recognition but can greatly shorten the time required for a decision.
- This can be win-win for both the EU and China.

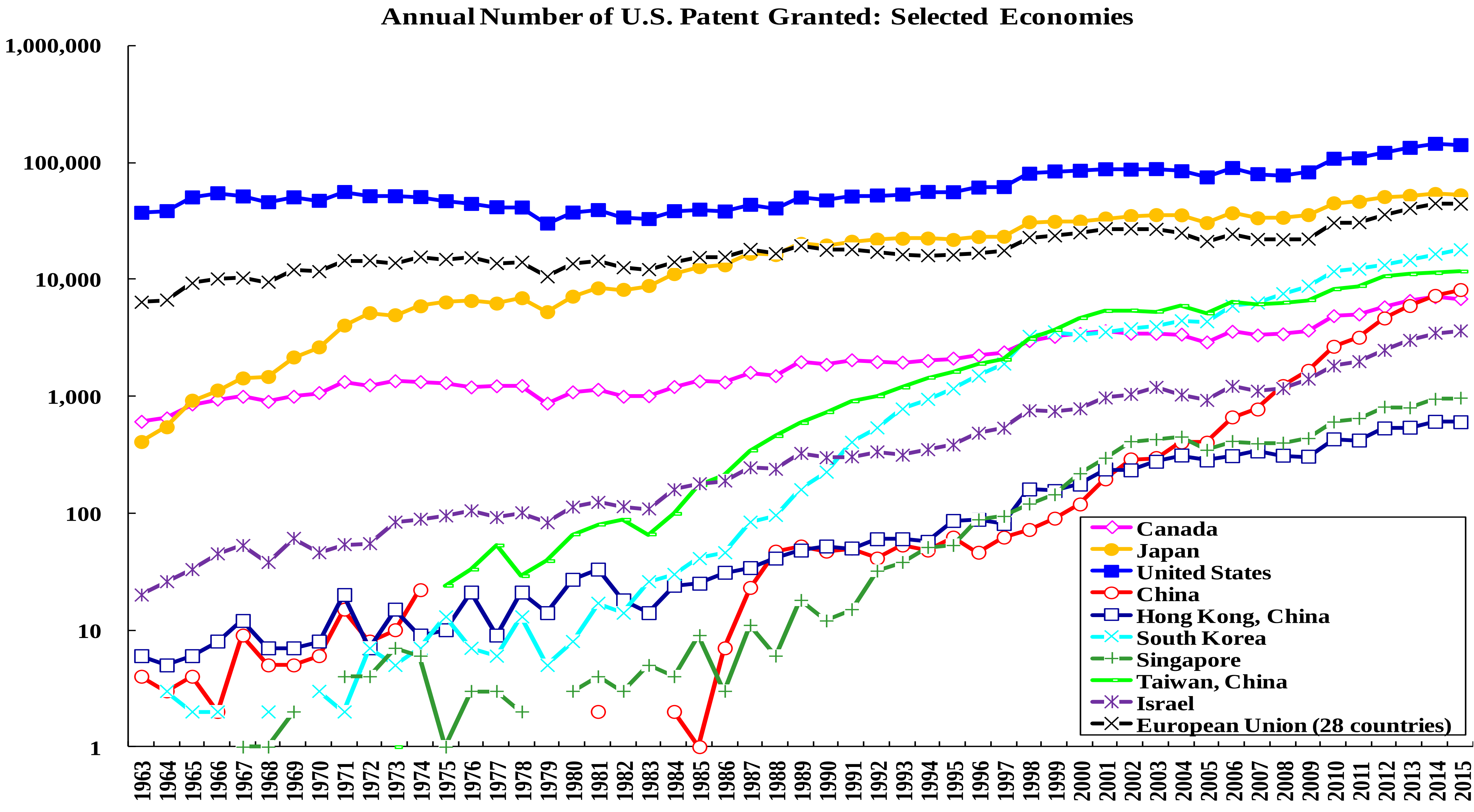
R&D Expenditure as a Percent of GDP: Selected Economies



Annual Number of Domestic Patents Granted: Selected Economies



Annual Number of U.S. Patents Granted: Selected Economies



Scientific and Technological Cooperation: Intellectual Property Protection

- The huge combined EU-China market can enable innovators to exploit the economies of scale in innovation. A huge market greatly enhances the productivity of intangible capital (e.g., R&D capital and goodwill including brand building) by allowing the fixed costs of the R&D for a new product or process, or advertising and promotion in brand building, to be more easily amortized and recovered.

Scientific and Technological Cooperation

- The European Organization for Nuclear Research, known as CERN, is a European research organization that operates the largest particle physics laboratory in the world. China can contribute both financial resources and scientific manpower to CERN.
- The EU and China can collaborate on research on the breeder-reactor and perhaps even the fusion reactor, which can be extremely beneficial to the decarbonization campaign.
- EU and China can work together to develop a new generation of airships for cargo transportation, especially to and from places with poor existing transportation infrastructure. An airship can in principle deliver goods from Paris to Shanghai in 60 hours, significantly cutting the time in transit that results in substantial direct and indirect savings.
- Cyber-security is another area in which the EU and China can also cooperate fruitfully.

Concluding Remarks

- If current trends of economic growth continue, it is projected that the Chinese economy will surpass the U.S. economy to become the world's largest economy around 2030. The Chinese economy will also surplus the EU some time before 2030.
- There is a great deal of room for trade and investment between China and the EU to grow, and for other areas of economic collaboration and cooperation between the EU and China to grow as well. A long-term strategic relationship between the EU and China, which together account for more than a third of world GDP and two-thirds of world trade, can accelerate the realization of these opportunities.