3.1. INTRODUCTION

As the European Union was recovering from the deepest economic crisis since the euro was created, a number of new challenges popped up. First and foremost, Brexit in June 2018 and a growing number of anti–European and/or populist governments with the most recent – and probably most relevant case – being Italy. Beyond those internal problems, another external shock has hit the EU in 2019, namely the trade war between the US and China. The US–led trade protectionism against China affects the European Union in several ways. First and foremost, it puts at risk multilateralism in trade relations and, in particular, the good functioning of the WTO (Jean, Martin, and Sapir, 2018). In addition, it opens the door to additional trade protectionism with could possibly target the EU as it sits on the largest trade surplus in the world. Third, trade measures taken by the US against China as well as China retaliation have indirect consequences on Europe. These can be positive for some sectors and European exporters have gained a comparative advantage against US exporters in China markets for the US goods on which import tariffs have been imposed and that Europe can produce (Wolff, 2018). Conversely, European exporters have an advantage in the US market compared to Chinese exports for those sectors targeted by the US with tariffs. However, this positive scenario gets blurred when one thinks of the complexities of the global value chain which can lead to increases in European costs of production due to third countries’ import tariffs as long as they lie within Europe’s production chain (Chiacchio, 2018). This is, no doubt, the case of China.

1 Senior Research Fellow at Bruegel and Professor at Hong Kong University of Science and Technology.
Given the above complexities, it sees important to analyze in detail what has happened so far on the US–China trade war and beyond trade as this article will hold the view that trade is just one of the facets of much more structural economic confrontation between China and the US. Second, we move to analyse the EU’s potential gains on the basis of the trade measures taken by the US and China on each other can help us focus on Europe’s potential gains, at least at a sectoral level. Finally, a review of Europe’s strategic options in a world than tends to be increasingly divided in two blocks (China and the US).

The paper is divided into 5 sections. The first section is to introduce the background of the US–China trade war. The second section is to provide a review of US–China trade protectionism and the impact of trade war on China and the US. The third section is to show a sectoral analysis of trade measures taken by China and the US. The fourth section illustrates EU’s first–best strategy regarding the US–China trade war. The fifth section discusses how EU behave in the US–China trade war.

3.2. AN ACCOUNT OF US–CHINA TRADE PROTECTIONISM

From seemingly untargeted measures announced in early February for solar panels and washing machines (Table 1), the US has moved to increasingly targeted action against China. The most obvious case in point was the announcement of 25% additional import duties to be applied to USD 50 billion equivalents of imported goods from China on the basis of China’s infringement of intellectual property rights (Garcia Herrero, 2018a). More importantly, about two thirds of those import tariffs have been applied since July 6. The US’ speedy introduction of the announced import tariffs, without allowing for much time to negotiate a deal between China and the US, shows that the US resolve to move away from the status quo in terms of the functioning of the global trading system, at least as China is concerned. On that basis, China had no choice but to retaliate with equivalent import tariffs on US goods.

Since then, the list of Chinese imports that the US is aiming at increasing tariffs has expanded again to an additional USD 200 billion. Thanks to a three–month truce reached recently at the side–lines of the G–20 summit, the additional USD 200 billion goods from China will not be confronted with a 25% import tariff yet but it looks increasingly clear that this is just a truce to buy time from both sides and that confrontation is escalating. The recent arrest of a Huawei’s CFO because of a potential breech of sanctions against Iran is the proof of the pudding of how far the US is ready to go in weaponizing is current hegemonic position as rule setter.

Going back to the trade war, China’s ability to retaliate on trade is obviously more limited as it does not import enough good from the US to match the announced USD 200 in import tariffs from the US, which explains that China’s second batch of second retaliatory measures have been more moderate, at least in size (USD 60 billion). Also the latter have been put on hold thanks to the recently agreed three–month truce.
### TABLE 1. US TRADE MEASURES

<table>
<thead>
<tr>
<th>Type of Product</th>
<th>Solar panels/Washing machines</th>
<th>Steel / Aluminium</th>
<th>Intellectual Property (1102 products valued at USD 50bn)</th>
<th>Intellectual Property (6031 products valued at USD 200bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rules</td>
<td>Section 201 Import Relief for Domestic Industries</td>
<td>Section 232 National security</td>
<td>Section 301 Intellectual property laws</td>
<td>Section 301 Intellectual property laws</td>
</tr>
<tr>
<td>Effective Date</td>
<td>7th Feb</td>
<td>23rd Mar</td>
<td>25% additional duty effective on July 6 for 818 products (worth 34bn) included in the proposed list on April 6, and 284 products (worth 16bn) will undergo further review.</td>
<td>10% or 25% (under public review until August 30, 2018)</td>
</tr>
<tr>
<td>Exemption</td>
<td>«GSP– Eligible» developing nations¹</td>
<td>Australia, Argentina, Brazil and South Korea²</td>
<td>Targeted at China</td>
<td>Targeted at China</td>
</tr>
<tr>
<td>Applied to China</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>Retaliation from China</td>
<td>N/A</td>
<td>Tariffs on $3 billion of 128 products including pork, fruit, nuts and wine of up to 25%</td>
<td>25% duty effective on July 6 for 545 products valued at about $34 billion and 114 products valued at about $16 billion with no effective date announced</td>
<td>5207 products valued at USD 60bn (duties of 5, 10, 20 or 25 percent)</td>
</tr>
</tbody>
</table>

N.B. 1 Philippines and Thailand are not excluded, even though they are GSP–Eligible. 2 Exclusions from US steel and aluminium tariffs may take 90 days.


The market reaction so far seems to have been more negative for China than the US, at least as far as the stock market is concerned (Chart 1 and Chart 2), which has lost more than 20% year to date. Furthermore, the RMB has depreciated quite substantially since the beginning of the trade war until recently, helped by the recently announced truce between the US and China. One may wonder whether the market is overreacting to the potential consequences of such trade war on China or, perhaps, underestimating the impact on the US. So far European markets seem to have remained relatively more insulated from the US–China trade war except when the US pointed towards protectionist measures against Europe directly, as was the case when the temporary lifting of the tariffs...
on steel and aluminum were lifted in spring and the threat of import tariffs of autos and auto parts was raised in early summer.

Moving on to the potential economic impact of the trade war, there have been attempts to estimate the direct impact of tariffs on trade and, thereby, on growth. For example, the IMF in its latest World Economic Outlook has estimated that the Chinese economy would grow 1.6% point less in 2019 and the US economy will grow 0.9% point less in 2019 if the trade war were to be maintained in 2019. Economic Outlook has estimated that the Chinese economy will only grow 0.2% point less in 2019. In the same vein, estimates of price and income elasticities of Chinese exports into the Chinese economy will only grow 0.2% point less in 2019.

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Source: Bloomberg, Natixis.

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example, the IMF in its latest World Economic Outlook has estimated that the Chinese economy would grow 1.6% point less in 2019 and the US economy will grow 0.9% point less in 2019 if the trade war were to be maintained in 2019. Also, the Euro area’s growth rate would be shelved by 0.4% in that scenario. The World Bank, instead, has a much more benign scenario in its latest global economic prospects, as it has estimated that the Chinese economy will only grow 0.2% point less in 2019 and the US economy will grow 0.2% point less in 2019. In the same vein, estimates of price and income elasticities of Chinese exports into the US by Garcia Herrero (2018b) point to a relatively limited value of China’s total exports affected by tariffs. Even if the USD 200 billion Chinese were to be confronted by full 25% tariffs, the overall impact on Chinese trade would be limited to only 3% of China’s exports and only 1.3% of the US’ exports (Chart 3).

Overall, the reason for this relatively limited economic impact, especially when compared with the very negative market reaction, especially for China, is that such exercises only take into account the direct effects on tariffs on trade and not indirect effects on investment through a worsening of market sentiment, among many other channels. The impact on expectations and, thereby, future investment, is probably behind the market fear; especially in China but also in the US and, to a lesser extent, Europe.

The issue is that market may be realizing that the risk is not only protectionism but much more than that as the US’ ultimate goal is to try to contain China. In fact, investors both in China and abroad are starting to worry that their investment is possible to be completed blocked by the US or indirectly affected by the worsened relationship between China and the US (Garcia Herrero and Xu, 2018). Moreover, the multilateral trade order maintained by the US is likely to be massively transformed. If that happens, the world will have to return to a much less free system for goods and service flow. It is due to the increasing uncertainties that the market investors’ sentiment have become more and more negative.

One way to go about the potential impact of the ongoing trade war might be to look in more details at the measures taken so far and analyze its rationale so as to draw conclusions about their potential consequences down the road.
3.3. A DEEPER ANALYSIS OF THE TRADE MEASURES TAKEN BY THE US AND CHINA

The analysis of the sectoral composition of the goods targeted by the US administration would support the view of relevant structural changes to happen in the global economy due to the trade war. The first round of the US tariffs (USD 50 billion) aiming at China’s high-end exports with a view to contain China’s technological advance, with 7% of the products on the very high technology products and 55% on the high technology products (García Herrero, 2018c). Some of the products included in the US tariff list has yet not been Chinese exports to the US, such as aircraft and aerospace or arms and ammunition, so the US’ true intention of the tariff is not reducing trade deficit with China, but to contain China’s moving up the technology ladder. By including products that do not contribute at all to the US bilateral deficit with China, one could argue that the US is revealing its preferences, at least indirectly, which are to contain China in what it wants to become, namely a technological power that competes with the US in high-end products.

Very interestingly, China appears to have realized quite quickly of the US intention as it has rapidly modified its own retaliation list from a more balanced one which included high-end imports from the US (including aircraft and aerospace) to one more focused on low-end products, such as agriculture (especially soy) and energy. Such a strategy makes sense in as far as imposing tariffs on high-end products which China does not yet produce or cannot be sourced anywhere else would only hurt China. This is because it would only increase the price of products needed for China to achieve its ultimate objective, namely, to move up the ladder of the value chain.

Moving on to the second set of import duties announced by the US, namely that of USD 200 billion to be imposed by August 30, the product composition seems to be very different. In fact, low-end products dominate but, interestingly, very few of them are final – especially consumer – products (with only 22% of total) but rather intermediate products. One could interpret this second wave of import tariffs as a way to re-shore the production of intermediate goods back to the US (or at least to a third country which is not China) and reduce China’s role in the global value chain. This interpretation of the second round of tariffs could have tangible implications for third countries which are now part of the value chain and have better economic relations with the US (even a free trade agreement which insulates them from increases in US import tariffs across the board). This is the case of Vietnam as well as Mexico (if NAFTA is finally renewed). But the US has silently removed some key products which would be expensive to substitute in terms of increase in prices for the final consumer (such as white goods for which China has become the largest supplier by far).

For this second round of tariffs, China’s retaliation is much smaller with only 60 billion due to the limitation of the total volume China imports from the US. Yet, it is already a large bulk of the total retaliation list China can further extend. In this round of retaliation, all low, medium and high technology stuff are included which shows a determined stance that the Chinese authorities will not retreat from the US threat. Also, more high-technology products as China’s imports from the US are limited (Chart 4 and Chart 5).
CHART 4. A COMPARISON OF THE US-CHINA TARGETED PRODUCTS RELEASED IN JUNE AND JULY (%)

Source: Natixis, USITC, UN Comtrade.

CHART 5. DECOMPOSITION OF US' IMPORTS FROM CHINA UNDER THE 200 BILLION TARIFF LIST

Source: Natixis, USITC.
3.4. WHAT IS THE IMPACT OF EUROPE?

Based on the above (namely the structural nature of the trade war between the US and China) the question to ask ourselves is how this may affect Europe.

While a trade war can hardly have any winner in absolute terms, as trade is generally beneficial for global growth, there could be some relatively worse or better outcomes depending on the country and sector. If the current dispute between China and the US moves on with punitive tariffs upon each other, the market space left out in the two giants’ territory should be, to a certain extent, filled by competitors from the rest of the world. As the biggest economic bloc in the world, the EU is, without doubt, a potential winner in this aspect. So far, the EU is the second largest exporter to both China and the US. This makes the EU exporters most likely to take up the market shares of both of China and the US’ companies in midst of the trade war.

**CHART 6. CHINA’S TOP 10 IMPORTS FROM THE US IN 2016 (USD BN)**

Source: Natixis, UN Comtrade.

**CHART 7. CHINA’S TOP 10 IMPORTS FROM THE EUROPE-5 IN 2016**

Source: Natixis, UN Comtrade.

*N.B. Europe-5 includes Germany, the U.K., France, Italy and Spain.*

*Note: The same color indicates the overlay of the US and the EU’s exports to China among the top 10 imports in China.*

At first sight, the size of the US market (€ 375.5 bn) is bigger than that of China (€ 198.2 bn), which seems to give the EU more opportunities in the US market than Chi-
na’s market. However, a more granular product–level analysis is needed to understand which sectors can potentially benefit from the trade war. When comparing the export structure of the three economic areas, we find that EU and US companies export more similar products than Chinese corporates, as it could not be otherwise, given the three regions’ different level of development. For example, the top 10 Chinese imports (at the ISIC 2–digit level) from the US and the EU are exactly the same including Transport equipment, Motor vehicles, Medical instruments, Machinery & equipment and Chemicals (Chart 6 and Chart 7). While in the US’ market, the top two exporting products from China include Office, accounting & computing machinery and the white goods, which are not even top 10 exports from the EU yet (Chart 8 and Chart 9). This means, if the US and China are crowding out each other’s exports, the EU’s exporting structure would suggest more chances in China’s market. Also, European products are potential substitutions of American products in the Chinese market but also the other way around, namely substituting Chinese exports into the US by European ones. It goes without saying that, for Europe to reap such benefits, it would need to remain neutral in its trade policies and refrain from aligning from the US to impose tariffs on Chinese goods.

**Chart 8. The US’ Top 10 Imports from China in 2016 (USD BN)**

Source: Natixis, UN Comtrade.

**Chart 9. US Top 10 Imports from the European-5 in 2016 (USD BN)**

Source: Natixis, UN Comtrade.

N.B. Europe-5 includes Germany, the U.K., France, Italy and Spain.

Note: The same color indicates the overlay of the US and the EU’s exports to China among the top 10 imports in China.
In such a case, one could estimate the potential maximum gains of substituting Chinese exports into the US and the other way around in the sectors on which tariffs have been imposed upon. The end result is that some specific sectors can really benefit to the extent of nearly doubling their production for exports. This is especially the case of the general purpose machinery sector for the first USD 50 billion package of import tariffs imposed by the US. EU exporters clearly gain more from substituting Chinese exports into the US than the other way around. In other words, the EU dependence on the US goes well beyond the Atlantic Alliance and lands right on economic issues such as trade dependence.

To quantify the benefits for European companies, we first calculate the product overlap (at the HS–6 level) between EU and Chinese exports to the US market, and the EU and US exports to China’s market, respectively, and then confine the overlapping product list to the targeted products during the trade war. This gives us a list of the maximum gains that Europe can make for every product both in China’s market as well as that of the US. Finally, we match the HS–6 products to the 3-digit level ISIC Rev.3 sectors to get the maximum potential gains for EU. The relevant sectors are defined as those that have been targeted by the US or China (or both) with additional import tariffs and, at the same time, what the EU has already exported with certain product value (> $1 billion) into the US or China (or both).

In the first round of the crossfire, both the US and China targeted $50 billion products on each other. The biggest winners (with potential gains bigger than $10 billion) from China’s market are the EU’s aircraft & spacecraft and basic chemicals sectors and the general purpose machinery sector from the US’ market (Chart 10 and Chart 11). While both countries’ target the exact amount of imports, the potential sector gains are higher in the US’ market ($39 billion) than China’s market ($30 billion).

### CHART 10. EUROPE’S GAIN IN US’ MARKET FOR THE FIRST 50 BN TARIFFS ON CHINA (FOR SECTORS > $1 BN)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Attainable</th>
<th>Non-attainable</th>
</tr>
</thead>
<tbody>
<tr>
<td>General purpose machinery</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Medical appliances and instruments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Special purpose machinery</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Electricity distribution and control apparatus</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Electric motors, generators, transformers</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Furniture</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: UN Comtrade and the concordance table from WITS. The calculation of the sector’s maximum market gain is based on all the related goods in the first round of the tariff lists. The solid part of the bar indicates the EU’s current exports to the destination market.

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2 We use the concordance table provided by the WITS to converse the HS classification into the ISIC Rev.3 classification.
In the second round of the crossfire, the US has escalated the tariff list to $200 billion imported products from China (although the current three–month truce has limited the tariff increase to 10% instead of the 25% planned). This again gives the European firms more room to access to the US’ market, with the possible maximum gains reaching $97.6 billion (or 50% of total). The benefits will now be extended to some of China’s key exporting field such as office, accounting & computing machinery as well as furniture, both of which are already the EU’s top 10 exports to the US and have potential to substitute China’s exports (Chart 12 and Chart 13). That said, the two sectors are restricted in their current capacity to replace the related products in second round of the US’ tariff list, as China’s exports to the US on these products are more than seven times as large as the EU’s current exports so it takes longer time for the EU to accumulate enough capacity to take place of Chinese producers. On the other side, the EU’s relative benefits in China’s market is much smaller as the tariff list only covers $ 60 billion products in total (only $38.5 billion but a larger percentage of the total amount goods on which tariffs have been imposed upon, namely 66%). In China’s market, European gains will be extended to medical & precision products and basic chemicals, and to lesser extent, to general purpose machinery.

That said, European potential gains will very much depend on Europe remaining neutral on the US–China trade war instead of following the US by imposing import tariffs on China. If the EU is forced to pick the US side and impose its own import tariffs on China, China will probably also retaliate against EU companies. It should also be noted, though, that the potential gains to be made are bigger in the US (beyond the already

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3 In the calculation of the maximum gains, we take into consideration the capacity restrictions by imposing the maximum gains as three times as large as the current EU companies’ exports.
larger export revenues) largely due to more tariffs imposed from the US’ side. In other words, beyond Europe’s historical alliance with the US which will keep EU policies closer to the US than they would ever be with China, the EU also fears losing the US market even more than that of China as its export share to the US is larger than China (Chart 14) while China remains more relevant for EU imports (Chart 15). The fact that Europe, an overall next exporter, continues to maintain a bilateral trade deficit with China does not help (Chart 16). Obviously, a neutral stance as regards China is the best of all situations with some clear winners among European export sectors but the US clearly comes first in the EU’s interests even if you only focus on trade gains.

**CHART 12. EUROPE’S GAIN IN US’ MARKET FOR THE SECOND 200 BN**

*TARIFS ON CHINA (FOR SECTORS > $1 BN)*

Source: UN Comtrade and the concordance table from WITS. The calculation of the sector’s maximum market gain is based on all the related goods in the second round of the tariff lists. The solid part of the bar indicates the EU’s current exports to the destination market.

**CHART 13. EUROPE’S GAIN IN CHINA’S MARKET FOR THE SECOND 60 BN**

*TARIFS ON THE US (FOR SECTORS > $1 BN)*

Source: UN Comtrade and the concordance table from WITS. The calculation of the sector’s maximum market gain is based on all the related goods in the second round of the tariff lists. The solid part of the bar indicates the EU’s current exports to the destination market.
CHART 14 EU’S EXPORT SHARE TO CHINA AND US, 2007-2017, %

Source: UNCTAD.

CHART 15 EU’S IMPORT SHARE FROM CHINA AND US, 2007-2017, %

Source: UNCTAD.

CHART 16 TRADE BALANCE OF EUROPE WITH CHINA AND US, 2007-2017

Source: UNCTAD.
All in all, our analysis shows US–China trade frictions are here to stay as far as they respond to a fight for hegemony in the global economy. The US wants to contain China’s future – which basically implies direct competition with Chinese products in third markets. In that regard, Europe, being export oriented and with a similar economic structure can benefit by substituting some of their exports to China. This, however, requires no retaliation from the US towards Europe. Otherwise, it will be extremely difficult for the EU to keep a neutral stance on the trade war.

3.5. OPTIONS FOR EUROPE IN THE LIGHT OF INCREASING ECONOMIC COMPETITION BETWEEN CHINA AND THE US

What the US–China trade war has brought about is not only short-term trade tensions, but more importantly, a systematic shift of the trade order which has supported the world’s development for the past century. Undoubtedly, the US and China will be the most influential bloc in the 21st century, and their conflict is doomed to be long lasting. While the two countries may find some temporary solution to the current tariff disputes, their conflicts are intrinsically embedded in the competitive stance which could only exacerbate in the future. This is all the more natural when realizing that China’s economy is already as large as that of the US (at least in purchasing power terms and soon in USD terms) but, most importantly, will contribute more than three times the US to the global economy in the next 10 years (Chart 17). In other words, although the US is a more important market for Europe today, this will soon no longer be the case, based on the positive growth differential between the US and China, which continues to be very large.

CHART 17 CONTRIBUTION TO WORLD GROWTH (USD TRILLION, %)

Source: Nataxis.
The global influence of the US–China cold war will be persistent. At this turning point, as the world’s only one figure that can balance the power between the US and China, the EU has to decide how to respond to the trade war. There are several options under current discussion.

3.5.1. SAFEGUARD MULTILATERALISM?

The EU has been long called for economic multilateralism and is pushing for the reform of the WTO to adapt to China’s sheer size without having become a market economy. In fact, one could argue that one of the key areas of contention from the US side is indeed China’s different economic model while still being part of a free trade world. The European response to this reality is to keep, if not enhance, multilateralism, by reforming existing institutions, especially the WTO so as to impose market practices on all members in order to protect fair trade (Demertzis, 2018).

This really means that the WTO will need to address the issue of the large role of state-owned enterprises in the production of goods and services and the pervasive role of subsidies to the production. This would bring the WTO close to the US concerns over China’s unfair practices in international trade.

While the EU may easily find common ground on the key issues with the US (only if the current US administration were to engage in such reform which is not the case now), but the reform requests could be hard with China. In fact, the role of SOEs is considered key in China’s model of socialism with Chinese characteristics and, thus, impossible to dismantle in the foreseeable future. Chinese will argue that the role of SOEs remains moderate and, thus, should be a no issue for WTO reform. The Chinese have also borrowed the concept of competitive neutrality from the OECD and argue that they are increasingly close to applying competitive neutrality among companies operating in China. Garcia and Xu (2017) hold a very different view on the role of SOEs in the Chinese economy both because of its more pervasive influence but, more importantly, because of their very different nature to other SOEs in the world. In fact, the key reason for their unequal footing with the rest of companies operating in China, including private Chinese companies, is their preferential access to market in many sectors as well as their special connection with China’s long-standing party, namely the Communist Party.

That said, the EU will also find the US difficult to cooperate in the reform of the WTO. Since its arrival to power, Trump has pushed the «American first» policies and certainly not the support of multilateralism. In fact, the tariff measures taken by the US based on the «security» reasons while bypassing the WTO’s multilateral settlement mechanisms is a clear sign that the US may overthrow the multilateral value at its own interest.

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4 For more details as to how Europe can defend multilateralism in the world and what are the options for Europe, please Jean, S., Martin, P., and Sapir, A. (2018) and Wolff G. (2018).

5 According to China’s National Bureau of Statistics, in 2015 SOEs accounted for 38.8 percent of total assets for industrial enterprises above scale.
As such, while the US seems to share more of the market and democratic values with the EU, it does not seem ready to fully conform with the EU’s proposal for a WTO reform so as to preserve multilateralism.

Under such circumstances, it does not seem very credible for the EU to continue to push the agenda of multilateralism without the US and China. On the other hand, though, it looks extremely dangerous for the EU not to do as it is no longer a superpower, nor does it intend to be one. All in all, while continuing to make efforts to preserve multilateralism, Europe may need to explore other responses to the current standoff between China and the US, aware of the increasingly slim chance that multilateralism becomes the driving force again.

3.5.2. ENHANCING EUROPE’S RELIANCE ON THE TRANSATLANTIC ALLIANCE?

Another potential option for Europe is to keep the status quo while reinforcing it on the basis of an increasing economic confrontation between the US and China. In other words, the EU may also choose to lean completely on the US. The question is how wise it is to do so in the current environment with clear changes in the US attitude towards multilateralism. This is all the more disappointing in as far as it was the US, who pushed for such a system, as a way to create a safe environment for its allies and eventually to engage the rest of the world after the collapse of the Soviet Union.

The current US administration has made it very clear that multilateralism and open trade is something of the past. The gunfire that the US has triggered is not only against China but against many other countries including the EU. Only in 2018, the US has already threatened tariffs on steel, aluminium, and cars on the EU. It also criticized the EU for its large trade surplus against the US. Also, the US has criticized the EU for not fulfilling its economic responsibility on military spending as members of NATO. As such, the EU alliance with the US will be more costly for the EU than it has ever been as the US is not happy with the current distribution of costs and benefits of such Transatlantic Alliance.

More importantly, because the US has chosen a non–market bilateral way to deal with China as well as other issues, the EU’s complete support for the US will mean that it has to give up on its rule–based approach to problem solving and, thereby, its principles. This is obviously very costly for the EU as its own internal market is based on a strong rule–based system as well as for the world since the EU is the bastion of multilateralism. The case of the reform of the World Trade Organization is a clear case in point since the EU is really holding to it and would probably not manage to do so if pushed towards a relation of clear dependence from the US.

There is another practical reason which restricts the EU from leaning on the US completely. The EU is not a single country, but a group of 28 (soon probably) countries which have different views about the US and also about China. In fact, while Western Europe may be easier to unite against China, Eastern Europe, but also Greece and Portugal, and recently perhaps even Italy, may express opposing views as to a strategic alliance with the US which requires leaving China aside. In fact, the recent effort for the EU to es-
To establish an EU–level investment screening system resembling the US’ famous CFIUS has been vetted by some EU members so that its final version is really very limited in scope and hardly a threat for China. China has also created a platform with Eastern European and Balkan countries, the so–called 16+1, since all of these countries are part of China’s led Belt and Road Initiative (BRI). Many of these countries expect to ease their financial concerns through investment from China as well as to reduce their dependence on Brussels. This, in itself, poses problems for the EU and might actually push it even closer to the US notwithstanding the costs.

### 3.5.3. STRENGTHENING COOPERATION WITH CHINA

Strengthening cooperation with China is also a practical – albeit unlikely – choice for the EU in as far as its current strategic ally, the US, is moving away from multilateralism, thereby harming EU interests. In fact, not only is China’s economy of similar size to the US already today but its contribution to the global growth will be much bigger as previously shown. This means that the opportunities in the medium term should be bigger in China but under a very important hypothesis: market access.

This is why most of the discussion as to whether Europe should rebalance its economic partnership towards China, at least partially, boils down to improving European companies’ market access in China. Within that context, the EU started negotiating a bilateral investment agreement (BIT) with China at a time when the economic relations still have a positive perception from the European side but things have changed quite dramatically since then. In fact, the 12th round of BIT negotiations has been without an agreement. The key stumbling block is indeed market access for European companies in China and reciprocity, which is of course related to the perceived lack of market access.

Beyond market access, EU authorities are concerned about potential discrimination against EU investors operating in China, including explicit or implicit preferential subsidies for certain enterprises. Such discrimination may also be a factor for Chinese companies operating in Europe. While market access is a more general issue, potential discrimination by means of implicit or explicit subsidies has linkages to the role played by Chinese SOEs. This is not only true for the Chinese economy, but also for Chinese investment in Europe because a good part of it (most of it until very recently) originates from SOEs.

In China, SOEs have a much wider scope as they originate from the planned economy era when they dominated all sectors (either SOEs or collectively–owned companies). Most Chinese SOEs, even now, are not established on the basis of correcting market failure, but more to carry out government objectives. Chinese SOEs are bigger, more pervasive, more dominant than their EU counterparts, and more importantly, exist in nearly every key sector in Chinese society (Table 2). Against the backdrop, the Chinese government has created a special favorable environment for the SOEs. This actually triggered the concerns over their unfair competition in the international market and is one of the key barriers confronting China’s building economic alliance with the EU.
TABLE 2. SECTORIAL SALES DISTRIBUTION OF SOES, POES AND FOES IN CHINA IN 2008, IN PERCENTAGE

<table>
<thead>
<tr>
<th>Sector</th>
<th>SOE</th>
<th>POE</th>
<th>FOE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Health</td>
<td>58.92</td>
<td>41.06</td>
<td>0.02</td>
</tr>
<tr>
<td>Wholesale &amp; Retail</td>
<td>2.20</td>
<td>97.73</td>
<td>0.08</td>
</tr>
<tr>
<td>Construction</td>
<td>24.43</td>
<td>75.26</td>
<td>0.30</td>
</tr>
<tr>
<td>Culture</td>
<td>54.71</td>
<td>44.36</td>
<td>0.94</td>
</tr>
<tr>
<td>Education</td>
<td>34.06</td>
<td>64.85</td>
<td>1.09</td>
</tr>
<tr>
<td>Finance</td>
<td>21.74</td>
<td>76.78</td>
<td>1.48</td>
</tr>
<tr>
<td>Accommodation</td>
<td>25.96</td>
<td>71.60</td>
<td>2.44</td>
</tr>
<tr>
<td>Real Estate</td>
<td>7.32</td>
<td>90.11</td>
<td>2.57</td>
</tr>
<tr>
<td>Environment</td>
<td>43.65</td>
<td>53.51</td>
<td>2.83</td>
</tr>
<tr>
<td>Research</td>
<td>33.94</td>
<td>62.28</td>
<td>3.78</td>
</tr>
<tr>
<td>Lease business</td>
<td>26.94</td>
<td>64.65</td>
<td>8.41</td>
</tr>
<tr>
<td>Restaurant</td>
<td>4.00</td>
<td>86.96</td>
<td>9.04</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>15.11</td>
<td>75.26</td>
<td>9.63</td>
</tr>
</tbody>
</table>

Source: Bruegel based on China’s Economic Census Data. Note: FOE = foreign–owned enterprise.

CHART 18. DESTINATION OF THE OVERSEAS COMPLETED M&A (THE PERCENTAGE BY NUMBER OF DEALS)

Source: Mergermarket, AEI, NATIXIS.
The hope of a EU–China BIT is that it should foster investment on both sides, but the reality is that, at this current juncture, Chinese investment into the EU is ballooning while EU investment into China is slowing down and is already smaller than that of China into the EU. More specifically, in 2011, China’s outward FDI (including that from Hong Kong) accounted for only 1 percent of EU total inward FDI, whereas China took 3.5 percent of the EU’s outward FDI. Given the size of the Chinese economy in the world already in 2011, this can be considered relatively modest. The situation today is very different. Chart 18 shows that EU has been seen the largest growth in attracting Chinese investment since 2016, particularly in the industrial and ICT sectors where China has been eager to cooperate to climb up on the technology ladder (Chart 19). Because the US has closed its door to China on the basis of «national security concerns», the EU is now the only place that is easier for China to access in buying foreign companies.

All in all, given the increasingly difficult relation with the US, a certain degree of rebalancing towards China should be explored by the EU. However, the key stumbling block will continue to be China’s state capitalism and the lack of market access to foreign companies. For the specific case of state–owned ownership, preferential market access in China, rather than ownership of SOEs, should be the key consideration for European policy makers when evaluating the undue advantage enjoyed by Chinese corporates. This is because private companies with ties to the Chinese government might also ben-
efit from preferential market access. The recent case of Huawei shows how much the Chinese leadership may fall behind key private companies, especially if they belong to strategic sectors.

More generally, the first priority issue that an EU–China BIT should pursue is market liberalization, so that any market access granted through the BIT puts European companies on an equal footing to their Chinese competitors (even with SOEs). This obviously requires, at least, reciprocity (García Herrero and Xu, 2017). In fact, market liberalization is important not only for foreign companies but also for Chinese private companies so that gains are also shared with China (European Parliament, 2016).

While engaging with China in the liberalization and opening up, the EU cannot remain fully open to China’s acquisitions of technology and the competition of Chinese state–supported companies in the single market. Europe has just announced a stricter framework for the screening of foreign investment (mainly directed at Chinese companies). Still, three key instruments might be used, with some reinterpretation of the EU Treaty, namely competition, dispute resolution and state aid policy. The first one does not require explanation nor state aid policy, with the caveat that it cannot yet be applied to non Member States. As for the dispute resolution, identifying unfair behavior by a firm can be easier after a firm reveals its status by operating in the EU market. An appropriate dispute settlement mechanism can protect both European and Chinese corporates. Among the different options, an investor–state dispute settlement system (ISDS) seems to be favoured internationally, but would need to be revised so that governments (either China or EU governments) do not fall prey to corporates suing them without clear justification. Furthermore, in the Chinese case, the very close links between corporates and the Chinese government (especially when operating abroad) could make ISDS a double–edged sword for the EU, because in certain cases China could, for its own purposes, support its enterprises in suing EU companies. In addition, the implementation of the ISDS might be difficult in China where experience with investor–state arbitration is rather limited and there is very low probability that the Chinese government will enforce foreign court decisions (US–China Economic and Security Review Commission, 2016). A revision of the ISDS is thus warranted to balance the interests of the parties in the BIT negotiation.

As such, we could see that Chinese internal reform is the key for the EU to pursue a better alliance relationship with China. The priority issue that EU and China need to pursue is market liberalization, so that any market access granted through the BIT puts European companies on an equal footing to their Chinese competitors (even with SOEs). This obviously requires, at least, reciprocity. Yet, there is still a long way towards the direction.

3.6. CONCLUSIONS

This paper reviews the impact of the US–led trade war against China and its immediate consequences, not only for China and the US, but specially for the European Union.
The first thing to note is that, although protectionism can never be growth enhancing, and certainly not for a net exporter like the EU, there are still gains to be made by European companies from the ongoing US–China trade confrontation in as far as they may be able to substitute US exporters into China or, less so based on our the findings in this article, Chinese exporters into the US. Unfortunately, the current truce agreed between the US and Chinese governments at the sidelines of the G20 meeting might reduce such opportunities for EU exporters and might even create trade diversion again from European products and in favour of American products.

The fact that the EU feels increasingly squeezed between the US and China in their strategic competition should push us to ponder on our options in the current global set-up. So far the EU’s option seems to have been to support multilateralism at any cost. Unfortunately, the latter is increasingly less likely as the US has no intention to revert to the model which it once helped create. On that basis, and given Europe’s reluctance to play a leading role without the US, the push for a return in multilateralism seems more an option of the past than an option of the future, let alone the present. The second most obvious option for the EU would be to increase its dependence on the US or, in other words, to push its strategic alliance further. However, but we should realize that this comes at a cost, more specifically two which were not as present before. The first is the increasing unreliability of the US as ally and a seemingly different distribution of costs and benefits for its allies (more costs for the EU, such as military expense, but less benefits on the trade side). The second caveat of a further reliance on the US is the need to align against China in issues of interest to the US. Although such issues are not too different from the complaints raised by the EU on China (market access, reciprocity, excessive role of the State in the economy and a stronger defense of intellectual property rights), the reality is that the US interest will come first in this battle. On the words, the EU could lose its potential preferential access to China because of a stronger alliance with the US. Finally, the third option, namely rebalancing toward China, at least partially, cannot be an option for Europe in the current circumstances because of a very limited access to the Chinese market. However, if China were really to further open up its economy to foreign competition (i.e., offer full market access), this option could become much more favourable. Based on the past experience since China entered WTO, this option seems highly unlikely but worth pursuing. In that context, China’s willingness to open up its markets to foreign competition clearly requires market access and reciprocity. While China makes up its mind on whether the above is a real option, the EU has not choice but protect its strategic sectors from China’s acquisitions and to safeguard the single market for unfair competition from Chinese SOEs.

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