



# TALKING POINTS

Commercial Relations Between  
China and the European Union

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## TALKING Points

# Commercial Relations Between China and the European Union

- Commercial ties between China and the European Union have grown dramatically since the PRC's opening in 1978, and China recently surpassed the United States as the EU's leading importer.
- While EU exports to China have grown rapidly in the 2000s, they still fall far short of EU imports from China, creating a huge trade deficit that is aggravating Sino-European relations.
- EU exporters face an array of barriers to the Chinese market, including local content requirements and preferential treatment of domestic companies.
- EU-China trade shows considerable variation by industry: Massive Chinese export surpluses in machinery and textiles/clothing; modest EU surpluses in transportation and services; a rough balance in chemicals.
- Among EU member states, Germany has achieved the deepest penetration of the Chinese market, illustrating the ability of German exporters to manufacture high value-added industrial products for which demand in China is strong.
- Exporters headquartered in other EU countries contemplating entry to China should avoid commoditized market segments and emulate the German model of upward migration in the value chain.
- Commercial activity between China and Central/Eastern Europe is quickening, led by Chinese exports to Czech Republic, Hungary, and Poland.
- Outbound foreign direct investment from Europe to China fell dramatically in 2007 parallel with an increase in EU FDI in the other BRIC countries and East Central Europe, signaling a recalibration of the emerging market strategies of EU companies.
- Foreign investment from China to Europe remains modest, but is certain to grow in coming years as Chinese-based strategic investors and sovereign wealth funds expand their EU positions.
- Trade and investment in China by European middle enterprises is dominated by a handful of high-performing companies, notably German "exportmeisters" that manufacture specialized industrial products that cannot yet be locally sourced.
- The European Commission is launching a dedicated facility to support European SMEs undertaking trade and investment in China.
- European middle enterprises pursuing growth opportunities in China should obtain specialized professional services to navigate China's complex business environment.

# Commercial Relations Between China and the European Union

The expansion of commercial relations between China and the European Union constitutes a signal development in the global economy.

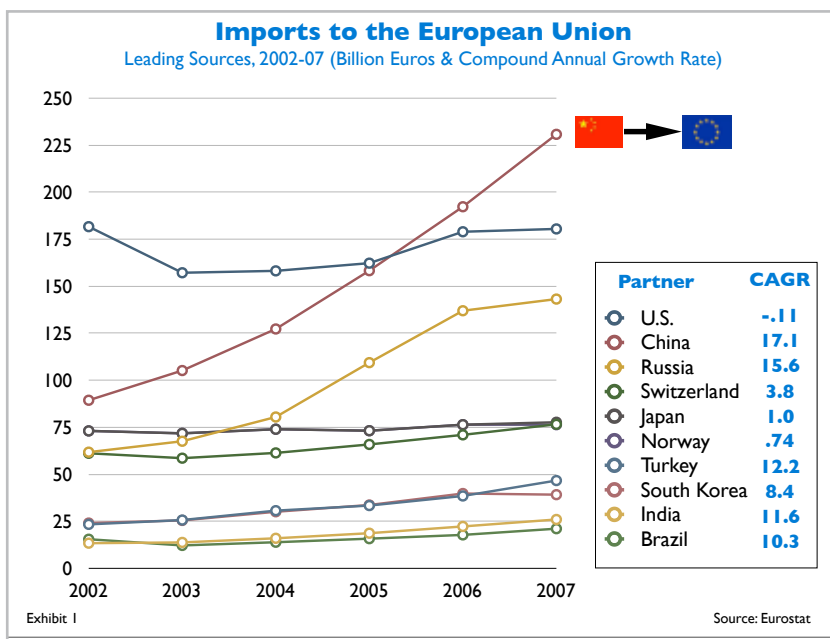
Sino-European trade has increased 60-fold since the PRC's opening in 1978. The EU is now China's leading foreign trade partner, surpassing the United States and Japan. China is the EU's foremost supplier of office machinery, textiles/apparel, and telecommunication products, and ranks near the top in EU imports of industrial machinery, electrical equipment, and other manufactured goods.

Cross-regional financial links are also deepening, as European companies exploit WTO-mandated liberalization of China's banking sector and Chinese investors enlarge their stakes in EU financial institutions. Meanwhile, Chinese and European small and medium enterprises increasingly look to each other's markets for profitable growth.

But while the Sino-European relationship has become a fulcrum of the world economy, that relationship is highly asymmetrical. Chinese exports to the EU dominate cross-regional trade, creating large imbalances that have become a source of friction between Beijing and Brussels. At the same time, once-robust flows of FDI (foreign direct investment) from the EU to China have plummeted as European investors reallocate funds to other emerging markets.

These developments illustrate the growing complexity of Sino-European relations and demonstrate the challenges facing EU and Chinese companies pursuing cross-regional commercial opportunities.

## Sino-European Trade

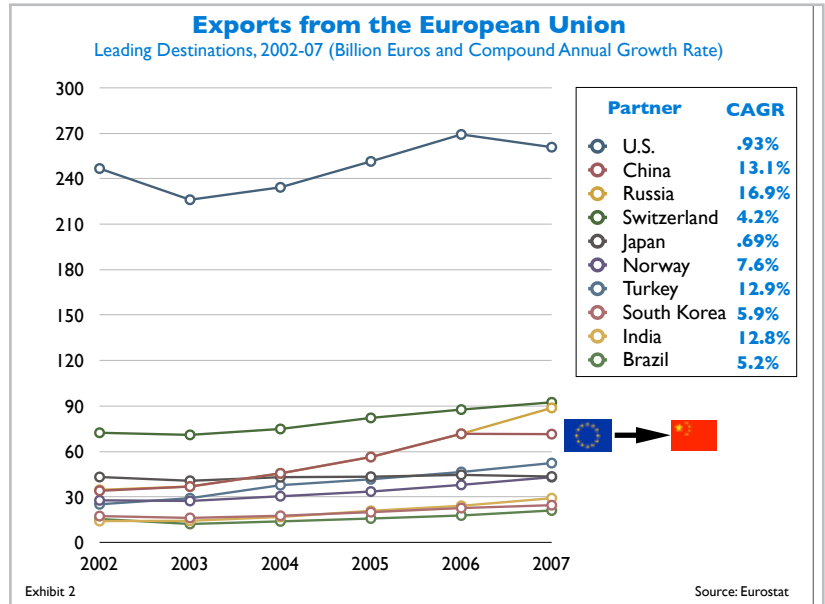


As shown in **Exhibit 1**, China overtook the United States as an importer to the European Union in 2005. Since the early 2000s Chinese imports have grown by nearly 20 percent CAGR (compound annual growth rate), the highest growth rate of any EU trading partner.

EU exports to China have also grown rapidly during the 2000s (13.1 percent CAGR between 2002 and 2007).

But EU exports to China lag far behind export sales in the United States (still the primary destination of EU exports despite the current downturn) and the Russian Federation (now the EU's most rapidly growing export market). Switzerland, with a population just 6 percent that of China, receives a bigger share of EU exports (**Exhibit 2**).

The result is a burgeoning trade deficit, which at 160 billion Euros in 2007 is the EU's largest trade imbalance. Mounting concern over the deficit has precipitated skirmishes over a range of trade issues:



- Product safety, notably Chinese-manufactured toys and pet food
- Dumping, particularly imports of low-cost Chinese steel products that have triggered a formal investigation by the European Commission
- GMOs (Genetically Modified Organisms), including Chinese rice imports that the Commission suspects contain an unauthorized genetically modified strain
- Trade in services, in which sphere the EU has notified the WTO of China's alleged violation of the "national treatment" provisions of the General Agreement on Trade in Services
- The trade-related effects of shifts in the Chinese renminbi, which amid a 14 percent revaluation against the U.S. dollar has fallen 10 percent against the Euro since the widening of the RMB trading band in summer 2005

Aggravating these trade disputes, EU concerns over Beijing's policies in Tibet and broader human rights record have impaired political relations and prompted the European Parliament to urge EU leaders to boycott the opening ceremony of the Olympic Games in August.

### Barriers to Trade

China's 2002 accession to the World Trade Organization yielded a significant liberalization of that country's vast market. The PRC reduced import duties on a wide range of manufactured goods and agricultural products. China's average final bound rate (9 percent) ranks below those of most other developing countries, and well below those of Brazil (27 percent) and India (32 percent). Furthermore, recent WTO-mandated changes in China's trade and investment laws have opened finance, professional services, and other sectors to foreign commerce.

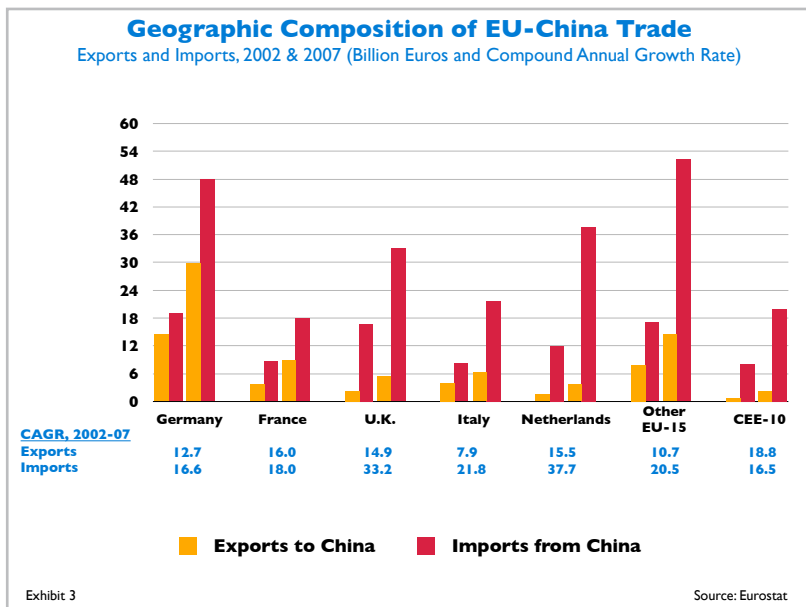
But European companies still face high barriers to entry in China. A 2006 report by the European Commission estimated that EU businesses lose 20 billion Euros annually as a consequence of market access problems in China. These barriers include:

- Enforced joint venture partnerships, which contravene WTO rules governing modes of entry
- Local content requirements, which prevent European multinationals from fully utilizing home-based vendors to supply their Chinese subsidiaries
- Preferential licensing of local companies in key industries, which are particularly egregious in China’s booming telecommunications market
- Intellectual property rights, which despite improvements since China’s WTO accession remain a serious concern for IP-sensitive European companies

Chinese and European officials are negotiating a new EU-China Framework Agreement, which replaces the original 1999 pact and which aims to accelerate China’s convergence toward WTO norms on intellectual property rights, customs regulations, technical barriers to trade, sanitary measures, and related issues.

Given the centrality of the Sino-European relationship in China’s development path, the Chinese government has powerful incentives to cooperate with the EU on lowering these barriers to trade.

European exporters therefore have grounds for optimism about the progressive opening of the Chinese market in coming years.



### Geographic Pattern of Trade

EU-China trade is not only highly imbalanced on the aggregate level. Cross-regional trade is strongly skewed towards a single EU country. As shown in **Exhibit 3**, Germany is by far the largest European exporter to China, accounting for over 40 percent of EU exports to that country. At 21 percent of the EU total, Germany is also Europe’s leading importer of Chinese goods.

While overall trade turnover between China and other EU countries (France, Italy, Netherlands, United Kingdom) is growing, export companies headquartered in those states have achieved much less success in China than their German counterparts. The gaps between the export and import growth rates of U.K, Italy, and Netherlands are striking, highlighting the sources of the huge Sino-European trade imbalance.

The ability of German exporters to crack the Chinese market resonates with the broader success of Germany's export sector, which despite high industrial wages and Euro appreciation has become the world's foremost exporting power. Germany's success in China reflects several factors:

- The concentration of Germany's export mix toward high value-added, premium-priced manufactured goods (capital equipment, precision engineering, technical and scientific instruments) that cannot yet be locally sourced in China
- The export orientation of German Mittelstand companies, many of which are leading producers of specialized industrial goods for which demand in China is high
- The previous entry into China of prominent German multinationals (e.g., Siemens, Volkswagen) whose Chinese subsidiaries pull substantial volumes of exports from mid-sized suppliers based in the home country

### **Trade Between China and Central/Eastern Europe**

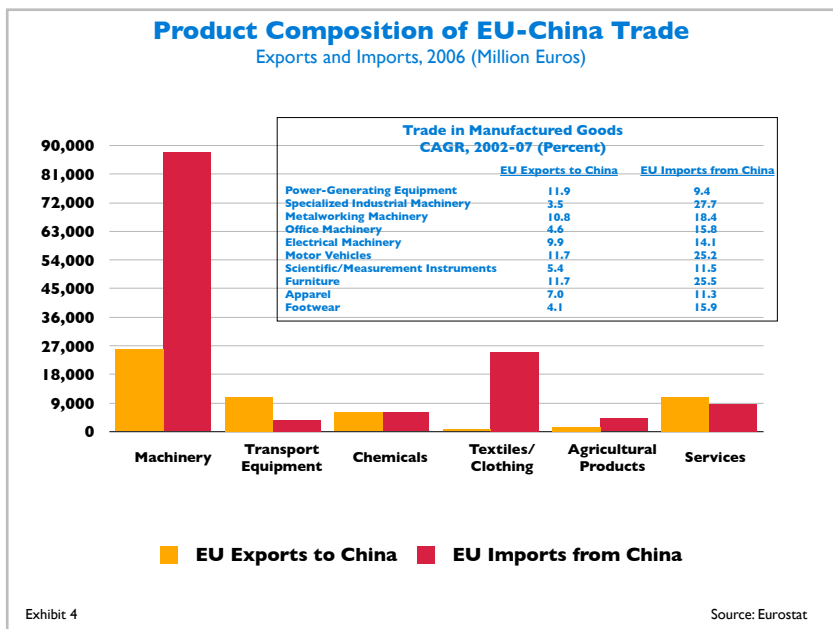
Also noteworthy is the deepening of commercial ties between China and Central and Eastern Europe. Starting from a low base, Chinese exports to the CEE-10 are rapidly growing, with three countries (Czech Republic, Hungary, Poland) accounting for nearly three-quarters of PRC exports to that region. This development reflects:

- The convergence of the East European accession states toward EU rules on foreign trade, which facilitates market access for Chinese companies
- The increasing purchasing power of CEE-10 households, whose demand for Chinese-manufactured consumer products is rising
- The expansion of trade-related investment by emerging Chinese multinationals, which look to Central/Eastern Europe as a platform to access the huge pan-European market
- Consistent with the overall pattern of Sino-European trade, Central/East European trade with China is highly imbalanced. In 2007, CEE-10 exports to China amounted to barely 12 percent of the value of regional imports from that country. The leading CEE exporter to China, Hungary, achieved a mere \$750 million sales last year.

But export-oriented companies headquartered in Central and Eastern Europe enjoy important growth opportunities in China, especially high-technology companies occupying specialized market niches (e.g., advanced manufacturing and professional services) in which Chinese demand is strong. CEE exporters surveying the Chinese market are well advised to emulate the German model: Avoiding commoditized, price-centric segments and moving upstream with high value-added products not yet available from local suppliers.

### **Product Composition of Sino-European Trade**

**Exhibit 4** presents a detailed breakdown of Sino-European trade by product category, and offers important clues regarding growth opportunities for Chinese and EU companies.



Machinery represents the largest sphere of Sino-European trade. The EU's trade deficit in that category stems from wide gaps in machinery export growth rates, especially specialized industrial machinery (27.7 versus 3.5 percent CAGR), metalworking machinery (18.4 vs. 10.8 percent), office machinery (15.8 vs. 4.6 percent), and electrical machinery (14.1 vs. 9.9 percent).

The EU enjoys a trade surplus into transportation goods, and a virtual balance in chemicals. Following the earlier

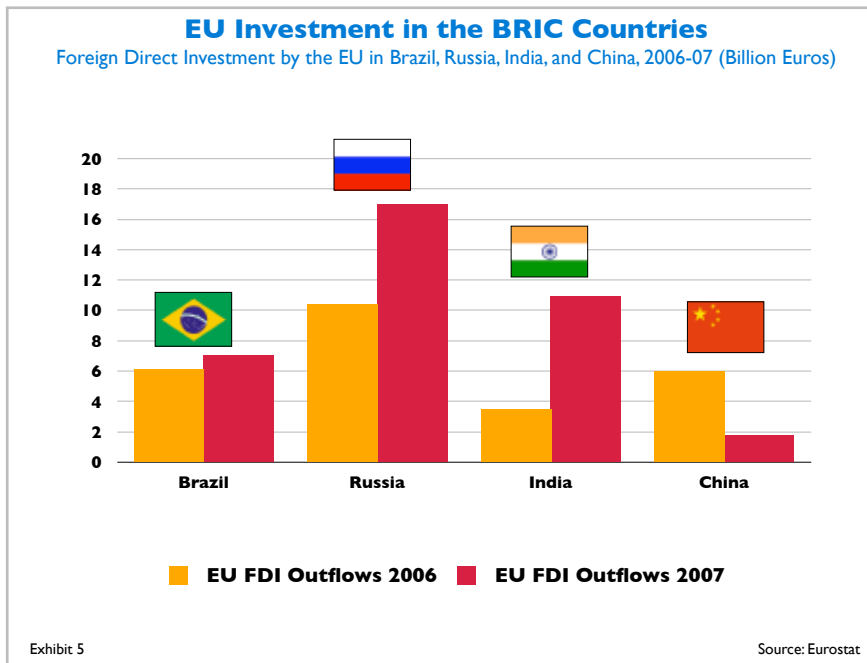
discussion, Germany possesses a commanding share of EU exports of machinery, transportation, and other manufactured products.

Illustrating the fallout of the 2005 expiration of the WTO's Multi-Fibre Agreement, China holds a massive trade surplus in textiles and apparel. That surplus is likely to widen following the January 2008 suspension of the temporary quotas enacted after the MFA expiry in response to protests by EU garment manufacturers over Chinese import competition. Some specialized European apparel producers have survived and even thrived in the post-MFA environment. But their trading activities are largely confined to the intra-EU market (where geographic proximity favors small, upscale local producers) and the pan-Mediterranean theater (where EU links to Turkey drive trade in textiles/apparel). Accordingly, China's domination of high-volume, commoditized segments of the European garment market will grow in coming years.

The EU enjoys a small trade surplus in services, reflecting the impact of WTO-mandated liberalization of China's service sector. Logistics, distribution, IT, engineering, architecture, and finance offer the best growth opportunities for European service companies contemplating the Chinese market. Mid-sized European companies are well positioned to reap growth opportunities in service-related trade with China, where barriers to entry are falling and scale economies are of diminishing importance.

### EU-Chinese Foreign Direct Investment

China received USD 128 billion foreign direct investment in 2007, fourth behind the United States, United Kingdom, and France and the largest FDI inflow of any emerging/developing economy. The Economist Intelligence Unit projects average annual FDI inflows of USD 135 billion through 2011, a trajectory that would vault China ahead of France and the U.K. in the global bidding for foreign investment.



For this reason, the dramatic falloff in EU investment in China is surprising. As shown in **Exhibit 5**, EU FDI in China declined from USD 6 billion in 2006 to 1.8 billion in 2007. During the same period, European investment in the other BRIC countries grew sharply. The Russian Federation, now a leading destination of EU trade and investment, captured \$17.1 billion FDI in 2007. EU investment in India quadrupled to USD 10.9 billion. Brazil, historically an FDI under-performer with shallow commercial ties to Europe, received USD 7.1

billion in 2007, over three times the level of European investment reaching China. EU investment in other emerging markets (particularly East Central and South Eastern Europe) is also growing while Chinese-bound FDI is shrinking.

FDI flow numbers for a single year provide only a snapshot of foreign direct investment, and therefore cannot serve as a basis for reliable projections of long-term trends. Moreover, annual FDI inflows tend to be lumpy, as the launching of foreign investment projects typically produce large capital injections in the first year before tailing off. Ad hoc internal transactions (e.g., intra-company loans) can also generate perturbations that skew annual FDI flows in one direction or the other. Furthermore, the above-cited FDI flow numbers do not include Hong Kong, which serves as a conduit for foreign investments ultimately destined for mainland China.

But the magnitude of the recent decline in EU-Chinese investment is cause for concern. The following are the key factors underpinning this development:

- The global credit crunch emanating from the U.S. sub-prime mortgage crisis, which has made it difficult for EU companies to assemble financing of foreign investments and compelled many European investors to postpone offshore ventures
- A diminution of reinvestment activity by European multinationals present in China, which in earlier years served to bootstrap sequential investments in their PRC subsidiaries
- A shift in the emerging market strategies of EU companies, many of which are already heavily invested in China but which now look to the late moving BRIC countries and the new CEE member states for investment opportunities

China's huge size, high GDP growth rate, and large installed European investor base make it very likely that EU companies will eventually reprioritize the country in their foreign investment strategies. Such a resumption of EU investment in China hinges on the results of ongoing discussions between Beijing and Brussels over intellectual property rights, ownership caps, and related FDI issues.

### **Chinese Investment in Europe**

In addition to its centrality as a foreign investment locale, China has become a major source of outbound FDI. EIU forecasts annual FDI outflows from China of USD 94 billion through 2011, third behind U.S. and France and ahead of U.K., Germany, Netherlands, and Japan.

Resource-related investment is driving the growth of Chinese outbound FDI, as mainland companies lock down sources of oil, gas, and raw materials around the world. But manufacturing-related investment from China is also growing, spearheaded by emerging Chinese multinationals (Haier, Lenovo, et al) that previously acquired world-class skills as contract manufacturers for leading Western companies.

Notwithstanding these trends, Eurostat reports very modest inflows (USD \$1 billion) of Chinese FDI in the European Union, 10 percent the amount originating in India. Again, this figure excludes outbound investment from Hong Kong, which functions as an entrepôt linking mainland China and external markets. It also excludes Chinese-based sovereign wealth funds, the largest of which (China Investment Corporation) holds USD 300 billion in assets and whose portfolio includes an increasing number of European investments.

Looking forward, Chinese investment in Europe is certain to grow in response to the following factors:

- The rising sophistication of Chinese-based strategic investors (whose outbound investments now consist mainly of South-South ventures) will embolden those players to follow the lead of Indian multinationals and expand their EU positions
- The elaboration of the EU's eastward enlargement project will heighten Central and Eastern Europe's allure to Chinese multinationals seeking regional platforms to service the pan-European market
- The continued growth of China's cash-rich sovereign wealth funds will broaden the scope of Chinese portfolio investment in Europe

### **Middle Enterprises in Sino-European Commerce**

As noted earlier, mid-sized companies in Germany's famed Mittelstand have achieved significant penetration of the Chinese market by leveraging their expertise in sophisticated, high-value manufactured products for which demand in China is growing.

But the Chinese successes of Germany's "exportmeisters" are very much the exception to the rule in the European SME sector. A recent survey by the European Commission ("Observatory of European SMEs") reported that 90 percent of small and medium enterprises in the European Union do no exporting at all. Another study published by Bruegel ("The Happy Few: The Internationalization of European Firms") found that outbound foreign trade and investment is concentrated in a handful of high-performance companies. The Bruegel study also found that the members of this exclusive club of European superstars reap substantial gains from internationalization: Greater profitability, higher productivity, greater value added, higher wages.

These findings underscore the opportunity costs facing European middle enterprises that fail to exploit growth opportunities in China and other foreign markets. To rectify that problem, the European Commission is launching a European Centre in China for Small and Medium Enterprises. The proposed center (based in Beijing) would facilitate trade, disseminate business intelligence, and provide other services to EU-based SMEs seeking to export and/or invest in China.

In addition to tapping the new European Centre in China, middle enterprises should obtain specialized professional services to navigate China's complex and rapidly changing business environment:

- Market Entry Strategy
- Foreign Partnerships
- Trade and Investment Regulations
- Tariffs/Non-Tariff Barriers
- Tax and Accounting
- Channel Development
- Risk Management
- Trade Finance
- Foreign Supplier Relations
- Human Resource Development

European middle enterprises contemplating entry to the PRC are also well advised to engage local advisors to manage the cultural dimensions of international business in China, which have proven vexing even for large EU multinationals with extensive global experience.

# BIOGRAPHY

## David Bartlett



David Bartlett, Economic Consultant, has over ten years' experience of consulting, researching and teaching on international corporate strategy. He specialises in international growth, global manufacturing, foreign sourcing and distribution and corporate risk management.

David's clientele includes multinational corporations and international financial institutions in North America, Europe, Asia-Pacific and the former Soviet Union.

Internationally recognised as an authority on financial sector development in Eastern Europe and the Soviet successor states, David is the author of a prize-winning book on the Hungarian transition and numerous articles on corporate strategy, international trade and investment and global finance.

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David has received a Fulbright Senior Scholarship, Salzburg Seminar Fellowship and other scholarly awards. He holds a PhD and BA from the University of California and an MA from the University of Chicago.

David has authored a number of articles on behalf of RSM International and most recently completed the RSM International Global Business Forecast.

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