BUSINESSEUROPE

RISING TO THE CHINA CHALLENGE

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EXECUTIVE SUMMARY

This report analyses the opportunities and challenges that China represents for European business. While China is a remarkable high growth market which offers a lot of prospects for European companies, it is also becoming a formidable competitor. China is no longer a developing country. It is a major industrial power in its own right. The EU must pursue a new cooperation strategy with this rapidly growing economic giant. This report explores different aspects of China's global competitiveness.

1 How has China emerged as an industrial power?

Whereas China's substantial trade growth is a testimony to its incredible rise, a large share of Chinese imports and exports are related to processing trade. However, China is fast becoming a leading producer in a number of important traditional industrial sectors where EU industry is a world leader: chemicals, automobiles, steel, machinery and engineering, metals, construction and textiles. While China's accession to the WTO in 2001 has opened its economy to international competition and global opportunities, some market inefficiencies prevail, including substantial support from the state to industry. There are also concerns about a slow-down in the WTO implementation and market opening process in China.

2 How does the Chinese state support the domestic and international development of its industries?

The State-owned Assets Supervision and Administration Commission (SASAC) still controls and develops the largest Chinese state-owned companies. By subsidising the price of energy and raw materials, the Chinese state also supports the development of important energy-intensive industries. Subsidies are also widely distributed through the Chinese economy in the form of soft loans. In addition, some industrial-political alliances on a local level openly discriminate in favour of especially state-owned companies.

The new strategic five year plan, which calls for the restructuring of China's industrial base to focus on high technology and renewable energy, presents new opportunities as well as some competitive challenges to EU industry.

The state continues to play a central role in supporting technological development through strategic mid- and long-term plans for scientific development. The report looks at Chinese policies that pressure EU companies to transfer technology on non-commercial terms to Chinese competitors.

Despite the efforts and improvements made to strengthen the rule of law in China, legal uncertainty remains a disadvantage for European companies. Weak enforcement notably at local level or openly discriminatory rules on intellectual property rights protection lie at the heart of the challenges. Since both Chinese and European companies will profit from strengthened intellectual property rights protection, further efforts and commitments should be made on IPR enforcement.

3 What is the impact of Chinese competition on the EU Market?

While the EU's bilateral trade deficit with China is significant, over the short run Chinese companies are not yet as big players as American or Japanese competitors. However, Chinese companies are increasingly investing in Europe, notably in strategic infrastructure and high-technology companies. Chinese company presence in procurement markets has also raised some concerns about them entering the EU market with subsidies. This concern is exacerbated by investment restrictions on the Chinese market. While increased engagement in Europe from Chinese companies is welcome, such investments must be on fair terms and based on a level playing field.

4 How important is Chinese competition on third markets?

In export terms, lower value added Chinese goods are expected to displace EU exporters in most emerging and developing country markets. In addition, Chinese development aid policies and tied aid arrangements put EU procurement providers at a significant disadvantage in developing countries. China is also pursuing a strategic resources policy to secure supplies of energy and raw materials. Over time, this threatens EU industries' access to essential raw materials.

KEY MESSAGES TO FOSTER EU-CHINA RELATIONS

1 The EU and China depend on each other in the global economy, with Chinese and European companies being parts of fully integrated global supply chains. The continously growing Chinese market is a top priority for European companies. European companies are well-positioned on the market, due to their international experience and strong presence on the Chinese market, cutting-edge technology, and the high quality of products and services. Both the EU and China should increase their efforts to further expand the opportunities through stronger bilateral cooperation.

2 Despite many large business opportunities, a number of issues make business operations with China challenging for European companies. Namely strong state influence on the market, discriminatory treatment, forced technology transfer, improved but still weak IPR enforcement, subsidies, restrictions on raw materials and the fear of retaliatory measures.

3 China should:

- continue market economy reforms in line with its WTO accession commitments and further open up sectors that are still closed to international competition. This relates notably to services and public procurement markets.
- allow foreign-ownership restrictions only for national defence. Moreover, foreign investment in China should not be conditional on the non-commercial transfer of technology or confidential information.
- increase the recourse to international standards and arrangements (like OECD provisions on export credits), strengthen and simplify IPR enforcement, enhance transparency and predictability, and address concerns over retaliation.

4 The EU should:

- react as a coherent block with member states not sacrificing common goals for individual interest e.g. while dealing with market access barriers. Although it has committed substantial resources to foster the bilateral relationship, differences of opinion within the EU prevent it from elaborating a coherent strategy towards China.
- develop the means to protect its companies and member states from Chinese pressure and intimidation. It should challenge Chinese infringements of trade rules – for example on subsidies or export restrictions – at bilateral and multilateral level.
- implement a strategic raw materials policy.

5 The EU and China should:

- use the High Level Economic Dialogue to define a work programme for bilateral discussions on trade issues.
- cooperate to support global adjustments of macroeconomic imbalances.
- better serve of Political Summits and other highest level meetings to advance on multilateral/plurilateral and bilateral agreements that will promote a more rules based trade and investment relationship. Some agreements that should be pursued as priorities are:
  - China's accession to the WTO Government Procurement Agreement on a substantial and meaningful basis mirroring the respective EU commitments;
  - The conclusion of the WTO Doha Round and the commitment to a post-Doha agenda in order to strengthen the multilateral trading system;
  - The negotiation of an EU-China bilateral investment agreement with China covering pre- and post-establishment of companies.

INTRODUCTION

This report examines the EU-China economic relationship and considers ways to strengthen the business partnership. It makes recommendations to allow companies from China and the EU to compete on a level playing field. The report focuses on three different areas where European business directly competes or cooperates with Chinese companies: in China, in the EU, and on third markets.

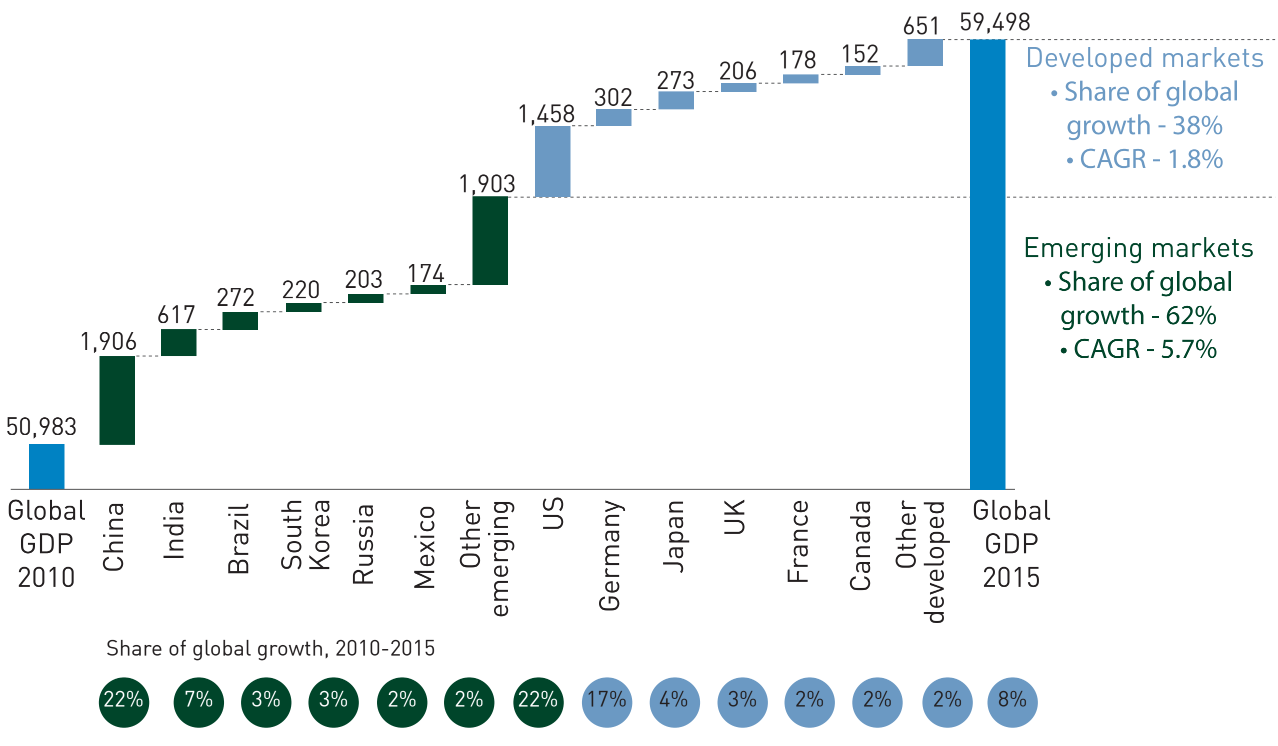
Due to its sheer size, the rise of China is having a big impact on the global economy. China has a population of over 1.3 billion people and has grown faster than any other major economy for the last 20 years. China's spectacular export growth has also shaken up global competition across most industrial sectors. Few industries can afford to ignore this growing industrial giant. As **Chart 1** shows, China is expected to be the largest contributor to global GDP growth over the next five years.

This high growth rate should contribute significantly to EU industrial growth and trade as European companies are well positioned to serve the Chinese market. But this also depends on the level and nature of competition they face in China.

In some ways, China is a classic example of a rising competitor. It has evolved from a closed economy towards a more open trade partner. The EU and China have established a stable relationship which is exemplified by the continuously growing bilateral trade and investment relations between the two economies.

But China is also a special case because of the dominant role of the state in economic development. Whether it is the allocation of resources, investments, or access to raw materials – the state, often through the levers of its state-owned-enterprises, controls the "commanding heights" of the economy.

Chart 1 The contribution of emerging markets to global growth
Source: Gearing up for growth, Accenture Institute for High Performance, March 2011



Through a sophisticated industrial policy China has been able to expand its global market share in trade significantly. The main challenge in dealing with China lies in this contrast between openness and control over the economy. Recently, European companies have been concerned that market access restrictions are on the rise in China. A policy of market closure could undermine one of the huge potential benefits of China's rise for EU business as a growing market for EU exporters. At the same time, Chinese companies are increasingly present on the EU market – including procurement markets at highly competitive and sometimes abnormally low prices. Chinese companies are also increasingly investing in EU companies with specialised industrial technologies. This will stimulate more competition at the high end of the industrial value chain in the future.

Competition with Chinese companies is even stronger on third markets. Indeed, China has two solid competitive advantages over the EU when it comes to international development:

- A substantial part of Chinese goods are low-cost, low-end goods which have bigger market potential in developing and emerging economies than EU goods which are higher up in the value chain.
- China's partnerships with developing and emerging countries are much more effective at promoting commerce than the EU's foreign and development policy. China is rapidly displacing EU companies from the resource sector and from public procurement markets as a result. The consequences for the EU's commercial and industrial interests are potentially serious.

This report analyses a number of key issues that are determining and affecting the EU-China relationship. Some subjects are more focused on the Chinese domestic market, whereas others look more at the EU and third countries. It is important to consider, however, that in a business environment characterised by global supply chains it is practically impossible to draw a clear line between domestic and third market factors. For example, China's policy on raw materials affects European companies in China, the EU and on third markets. Consequently, only a holistic view of the different chapters in this report gives an accurate picture of the challenges and opportunities facing European businesses and which are linked to the rise of China.

SECTION 1 THE GIANT HAS EMERGED

China's market reforms and impressive economic growth have been historic in their proportions. Today China is among the leading global economic powers. Over the past 15 years, China has tripled its global export market share from around 5 to over 16%. This places China well ahead of Japan (9%) and the United States (12.5%) and just behind the EU (19%).

China has developed primarily as an industrial economy – often referred to as the "factory of the world". Consequently, trade figures show that the EU-China relationship is dominated by industrial trade. Services trade and foreign investment flows are still relatively small in comparison. While EU exports to China have increased significantly – by between 20 to 30% per annum – the relationship is characterised by a massive trade deficit for the EU as shown in **Table 1**.

Table 1 The EU-China Trade Relationship
Source: DG Trade website, European Commission

Trade in goods
- EU exports to China 2010: **€113.1 billion** (+38% over 2009)
- EU imports from China 2010: **€281.9 billion** (+31% over2009)

Trade in services
- EU services exports to China 2009: **€18 billion**
- EU services imports from China 2009: **€13 billion**

Foreign Direct Investment
- EU outward investment to China 2009: **€5.3 billion**
- China inward investment to EU 2009: **€0.3 billion**

A recent WTO report shows that a large share of this deficit is characterised by processing trade, i.e. the assembly of semi-finished goods in China and their re-export to third markets.

Table 2 International trade, processing trade, and shares of Foreign Invested Enterprises (FIEs), 2007-09 (US$ billion, unless otherwise indicated)
Source: WTO Trade Policy Review on China, 2010

	2009
Total exports	**1,201.7**
Share of processing trade in total exports (%)	48,8
Exports of FIEs	672,2
Share of FIEs processed exports in total processed exports (%)	84,1
Total imports	**1,005.6**
Share of processing trade in total imports (%)	32,1
Imports of FIEs	545,2
Share of FIEs processed imports in total processed imports (%)	84,0

By outsourcing parts of their manufacturing to China and re-importing finished products into Europe, European companies have taken advantage of this opportunity to significantly lower production costs and increase productivity. While processing trade is dominated by Foreign-Invest Enterprises (FIEs), China is also expanding its indigenous industries rapidly. In many sectors, China has become one of the leading industrial producers and hence competitors to EU industry.

1 OVERVIEW OF SIX KEY SECTORS

A Chemicals

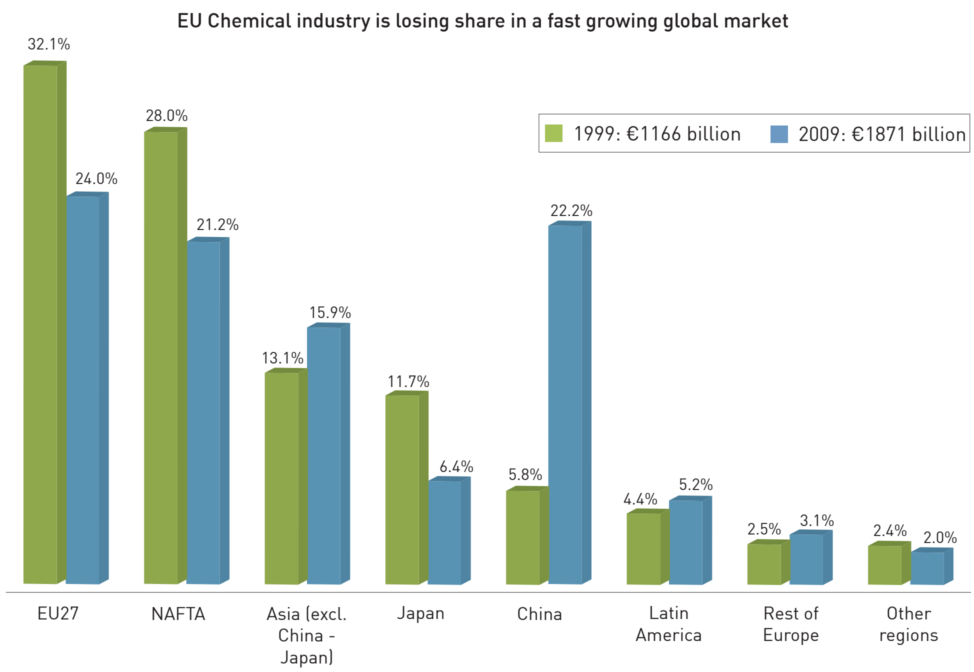
In 2009, China's chemical industry accounted for €416 bn in total chemical sales, which represents roughly a quarter of the sales generated by the 30 leading chemical-producing countries in the world (90% of world share).

China is also set to almost double its global market share from 2010 to 2020. The EU has a trade deficit with China in all chemical sub-sectors.

Today, the chemical industry is China's third-largest domestic industrial sector (after textiles and machinery) and accounts for roughly 10% of the country's GDP, which is very substantial compared to 4% in the EU.

While the impressive growth of China's chemical industry can be largely attributed to the demand generated by its industrial development, it has also benefited from considerable state support like artificially low energy prices. The largest domestic producers, Sinopec, PetroChina, ChemChina and China BlueStar are all state-owned.

Chart 2 Geographic Breakdown of World Chemical Sales
Source: Cefic Chemdata International



B Automobiles

Increasing demand from domestic consumers has made China the biggest auto market in the world. In 2010, China was the first manufacturer of cars and commercial vehicles with 18.26 million units – an increase of 32% over 2009. Chinese production now represents an impressive 23.5% of global car industry output, ahead of the European Union, Japan, the United States, South Korea, Brazil and India.

In 2010, EU car exports worldwide amounted to approximately 4.3 million units. Chinese exports, including foreign brands, already account for one fifth of this figure, with the major share of Chinese car exports going to the European Union and the United States.

The Chinese market remains dominated by joint ventures with foreign partners governed by strict local content requirements. The aim is to allow local producers to build up a highly competitive car industry in the future. As a strategically important industry it is expected that China will strongly interfere in this sector to foster the development of local producers.

C Engineering industries (machinery and electrical)

China's recent focus on green technologies will increase the demand for cutting edge energy-efficiency technologies in traditional sectors. In most subsectors, China is the leading trade partner of the European Union. Although European companies are among the most competitive in the world, **Table 3** shows that the sector is still characterised by large bilateral trade deficits in specific sub-sectors.

Table 3 EU-China trade balance in key manufacturing sectors
Source: DG Trade website, European Commission

	EU Imports				EU Exports				EU Balance
Product Groups	Rank	Millions of euro	Share of total EU imports from China	Share of EU imports in this field	Rank	Millions of euro	Share of total EU exports to China	Share of EU exports in this fields	Millions of euro
Office & tele-communication equipment	1	94,741.2	33.6%	49.4%	4	4,816.5	4.3%	6.3%	-89,924.7
Electronic data processing & office equipment	1	40,692.7	14.4%	54.9%	8	1,069.9	0.9%	4.4%	-39,622.8
Telecommuni-cation equipment	1	37,397.8	13.3%	50.3%	7	1,743.6	1.5%	4.7%	-35,654.3
Integrated circuits and electronic components	1	16,650.7	5.9%	38.4%	2	2,003.0	1.8%	13.2%	-14,647.7
Power generating machinery	2	2,350.8	0.8%	8.7%	2	3,422.4	3.0%	8.0%	1,071.6
Non electrical machinery	2	12,358.9	4.4%	21.8%	1	25,861.5	22.9%	14.7%	13,502.6
Electrical machinery	1	22,864.2	8.1%	39.4%	2	8,308.5	7.3%	12.7%	-14,555.7

D Metals and steel

Thanks to its endowment in natural resources (e.g. tungsten, tin, antimony, molybdenum), China has historically been a large producer of steel and non-ferrous metals.

Over the last ten years, China has become the dominant producer of most non-ferrous metals through an aggressive industrial expansion strategy.

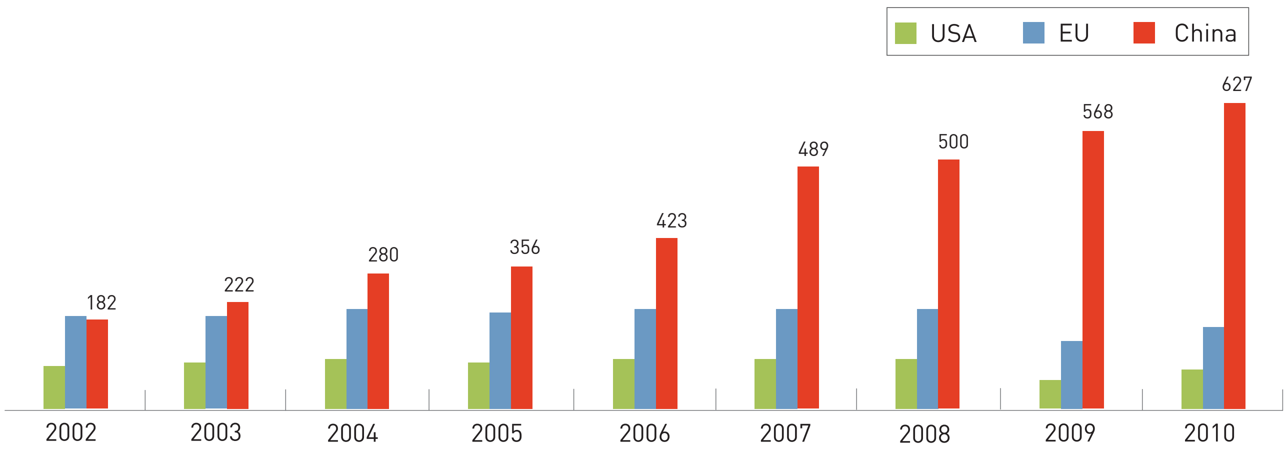
Table 4 China's share of world refined metal production (%)
Source: World Bureau of Metal Statistics, CDI

Metal	2000	2010
Aluminium	9	35
Copper	9	24
Lead	16	45
Zinc	22	40
Cobalt	3	38 (in 2009)

From 2000 to 2010, Chinese steel output increased by 345%. Its steel production has increased by a volume of 500 million tonnes which is two and a half times the average annual total production of the EU steel industry. China's share of global steel output rose from 20% in 2002 to 45% in 2010.

China's growth in steel production has far outpaced consumption. Over the last four years, annual steel exports on average were at around 35 million tonnes making China the biggest steel exporter worldwide and contributing to a negative steel trade balance with the EU (2 million tons of EU net imports in 2010).

Chart 3 Crude steel production in EU, China, US (million metric tonnes)
Source: Eurofer



China's strategic raw materials policy, infrastructure developments and long-term supply contracts combined with subsidised energy have been essential to enable its metals and steel industries to grow so quickly.

E Textiles

China's initial expansion into global markets was led by the textiles sector. Today, it remains the leading producer and is the EU's first textiles and clothing supplier. China accounts for roughly three quarters of the EU's trade deficit in textiles and clothing in terms of value.

In contrast, China is not a significant market for EU exports despite the positive trend in recent years – this explains the large trade deficit. China's dominance in this sector is driven by the availability of low-cost labour and raw materials.

Table 5 EU's total trade balance on textiles and clothing
Source: EURATEX

	2005	2006	2007	2008	2009	2010
EU deficit with extra-EU27	-35,901 bn	-41,811 bn	-43,891 bn	-44,309 bn	-44,499 bn	-49,747 bn
EU deficit with China	**-20,419 bn**	**-23,063 bn**	**-26,453 bn**	**-29,991 bn**	**-29,543 bn**	**-33,331 bn**

F Construction

The Chinese (state-owned) construction industry is growing at high speed due to the important public investments in infrastructure in China as well as internationally in Africa and Asia. China is creating national champions that are already amongst the largest construction firms in the world. Competition in the Chinese market is limited as foreign participation in Chinese public tenders is only possible in the form of Joint Ventures which are, however, subject to a discriminatory qualification regime.

"Wholly-foreign owned enterprises" are only allowed to take part in tenders that are not financed by Chinese authorities. As a consequence the share of FIEs in the Chinese construction market which amounted to 6% before WTO accession has actually declined to 1%.

China's rapid industrial development is not only a challenge for EU competitors; it is also a challenge for the Chinese economy to deal with over-investment. Overcapacity is a major problem in many Chinese industries caused by state, provincial or local support to industry to meet national growth targets in the face of low domestic demand. This overcapacity has also generated important trade frictions with China's trade partners.

Example — **Chinese overcapacity in chemicals and steel**

The China Petroleum & Chemical Industry Association (CPCIF) concludes that 20% of chemical and petrochemical products have overcapacity problems. This overcapacity has led many domestic producers to seek protection against imports, to request the maintenance of subsidised energy for industrial use and to resist further market opening in the WTO.

In the steel sector, the production capacity of seamless tubes installed in China was 80% higher than local demand and had even exceeded the total demand of the year. This forced Chinese companies to dump excess production on world markets.

In spite of the challenges, European companies have benefited from China's industrial development through increased trade and investment opportunities. EU companies will continue to benefit from this development provided that China pursues an open, non-discriminatory and non-interventionist economic and trade policy creating a level playing field for foreign and domestic companies alike.

2 WTO: CHINA'S PATH TO INTEGRATION IN THE GLOBAL ECONOMY

China's accession to the WTO in 2001 has symbolised the impressive opening of its economy to the world – and of the world to China. That such a dramatic shift in global economic development occurred smoothly is testimony to China's liberalisation policy and the benefits of a multilateral rules based trading system. China's exports have risen in more than five-fold from around €201 bn ($ 266 bn) in 2001 to €1189 bn ($ 1576 bn) in 2010. Beyond the increase in trade, the most positive effect of China's WTO accession has been the encouragement of domestic economic reforms and the improvement of the business climate in China.

But there are concerns about a slow-down in the market opening and WTO implementation process as underlined in the 2010 WTO Trade Policy Review. China could and should do much more to implement its WTO accession commitments and to address cases of non-implementation. Major concerns highlighted by the WTO include the lack of transparency, the elimination of burdensome regulations, the dismantling of non-tariff barriers to trade in goods and services, the removal of restrictions on foreign investment, the opening up of the domestic procurement market, the need for effective IPR protection, the removal of discriminatory raw materials policies, and the elimination of local content requirements.

In addition, China should take up more global responsibilities by making more substantial trade liberalisation efforts in the WTO, including the ongoing Doha round negotiations. Under the current Doha negotiating texts it could still benefit from an implementation period of up to 18 years and maintain high average tariff rates despite the competitiveness of many of its export sectors.

RECOMMENDATION

Implement WTO accession commitments and make ambitious steps in the Doha round

Open markets are essential for China's economic development due to its export focus and the integration of Chinese companies in global supply chains. China should therefore make more ambitious steps in the Doha round negotiations. Participation in specific sectoral agreements (notably chemicals, machinery and electronics) would increase its competitiveness, expand exports and reduce costs for downstream industries.

3 MARKET ECONOMY STATUS (MES) - CONTINUE THE REFORM PROCESS

Under its protocol of accession to the WTO, China was considered by most countries as a non-market economy. To work towards China achieving market economy status, the EU and China have agreed to cooperate on implementing much needed market and regulatory reforms in China. This cooperation bore some fruit as China rapidly moved away from barter trade and encouraged the more widespread use of modern accounting among firms. The EU contributed to the latter reform through training projects for accountants at the local level in China. Unfortunately, persistent Chinese dumping practices have hindered this positive cooperation.

China will automatically be granted MES in 2016 pursuant to its WTO Accession Protocol, and EU Anti-Dumping/Anti-Subsidy laws already enable the granting of Market Economy Treatment (MET) to individual Chinese companies operating under normal price conditions. Therefore the pressure on China to meet the EU criteria is diminishing. Ultimately, it is in the interests of both the EU and China that the Chinese economy is as efficient, transparent and predictable as possible. Considering the implications for EU companies of granting MES to China, the European Commission should conduct a thorough and impartial assessment of the current implementation of the MES criteria and work out, in cooperation with the Chinese authorities, a road map for their effective fulfilment.

RECOMMENDATION

Continue market economy reforms

BUSINESSEUROPE has identified priority issues where China should actively continue to build on the achievements of its reform process:

- continued reform of the Chinese financial sector;
- effective enforcement of company law and international accounting standards;
- implementation of market economy principles;
- avoidance of governmental interference in the decision-making of companies;
- elimination of discrimination or unjustified restrictions, both for domestic and foreign operators;
- transparency of fiscal instruments and application of national treatment principle;
- enforcement of basic legal principles (notably on IPR, standardization or certification, services regulations).

A real business to business dialogue could facilitate and support the discussions on market reform.

4 A LOOK INTO THE NEW FIVE-YEAR PLAN

In spite of efforts to evolve toward a fully functioning market economy, macro-economic guidance remains a fundamental feature of the Chinese economy. The 12th Five-Year Plan for National Economic and Social Development (2011-2015) focuses on "inclusive growth":

- Overall annual growth rate target: 7%, i.e. 4.2% lower than China's average annual rates during the 11th Five-Year Plan (2006-2010).
- Spread growth more evenly across the population, by raising urban and rural incomes through the expansion of government-funded social welfare.
- Keep urban unemployment below 5%.
- Create 45 million new urban jobs (i.e. the total population of Spain) over the next five years.
- Encourage the economic development of China's underdeveloped western regions.

The Five-Year Plan also identifies seven strategic emerging industries: biotechnology, clean energy, high-end equipment manufacturing, energy conservation and environmental protection, clean-energy vehicles, new materials and next-generation IT. The government is reportedly prepared to spend more than 4 trillion Renminbi (approximately €434 bn) to support these industries during the five-year period, with an aim to increase those strategic sectors contribution from today's approximately 5% of GDP to 8% by 2015 and 15% by 2020.

Depending on the sector, some companies in China may face tighter restrictions on energy consumption and associated increases in operating costs, while others may see greater business opportunities as the government aims to equip industries with advanced technology. Companies may also experience more cost increases because of mandatory wage raises. Benefits for EU firms from the Five-Year Plan will depend on China's implementation in a non-discriminatory manner, establishing a level playing field for European companies.

SECTION 2
CHINA'S STATE-DOMINATED ECONOMIC POLICY

1 THE VISIBLE HAND: STATE INTERFERENCE IN THE CHINESE MARKET

While China has opened its economy substantially to competition and has allowed for the development of a dynamic private sector, the hand of the state is still highly visible in the Chinese market. Whether it is through state-owned enterprises, discriminatory procurement policies or government subsidies, China is shielding its industry from competition domestically while simultaneously expanding internationally. This threatens the competitive position of EU business on both the Chinese and international markets.

A China's preferential treatment for National Champions and SOEs

A special characteristic of China's business environment is the preferential treatment that is given to Chinese companies in many sectors. State-Owned Enterprises (SOEs) particularly benefit from these policies, to the detriment of Foreign-Invested Enterprises (FIEs) as well as Chinese private sector companies. Chinese central SOEs are active in virtually all sectors of the Chinese economy.

State planning is also used to strengthen the position of SOEs. The 12th Five-Year Plan emphasizes the consolidation of traditional industries, such as petrochemicals, steel or non-ferrous metals, and the development of new strategic industries, where SOEs are dominent.

Examples of this industrial policy can be found in China's recent indigenous innovation initiatives, the protection of strategic sectors, or in the provisions related to public procurement. China's 4 trillion Renminbi (€434 bn) stimulus package favoured SOEs in spite of commitments from Prime Minister Wen Jiabao that the plan be open at central and local level to all companies. The 2010 WTO Trade Policy Review on China states that "SOEs have been benefiting disproportionately from the Government's economic stimulus measures to boost the economy, although the authorities maintain that this is not the intention of the Government. SOEs also have much better access to capital than private enterprises." This is due to the fact that a very substantial part of the government spending was dedicated to public procurement projects from which foreign companies often are excluded (see also section on public procurement in this report).

RECOMMENDATION
Apply strict competition rules in China and the EU

China should start privatization processes in commercial sectors and encourage the growth of private ownership and business. China should also apply its anti-monopoly law equally to all businesses, including SOEs and National Champions. The EU, which has extensive experience in applying competition law to SOEs, could assist China in developing and applying fair competition rules. In the meantime, the EU will have to adapt its own trade, investment and competition rules to deal with potentially unfair competition. EU competition rules should restore a level playing field when EU companies face competition from Chinese SOEs on the EU market. A new China specific Trade Barriers Regulation (TBR) should be established with specific rules to deal with unfair competition from Chinese SOEs – notably with an obligation for Chinese SOEs to cooperate with EU investigators.

It is not uncommon for countries to use SOEs to spur industrial development at the early stages. However, once a country achieves a certain level of development, it should continue with the privatisation of its SOEs where possible to allow fair competition. China is at the stage where it should establish a level playing field with fair competition for state, private and foreign companies on its market. The current economic model is discouraging the further development of a private sector.

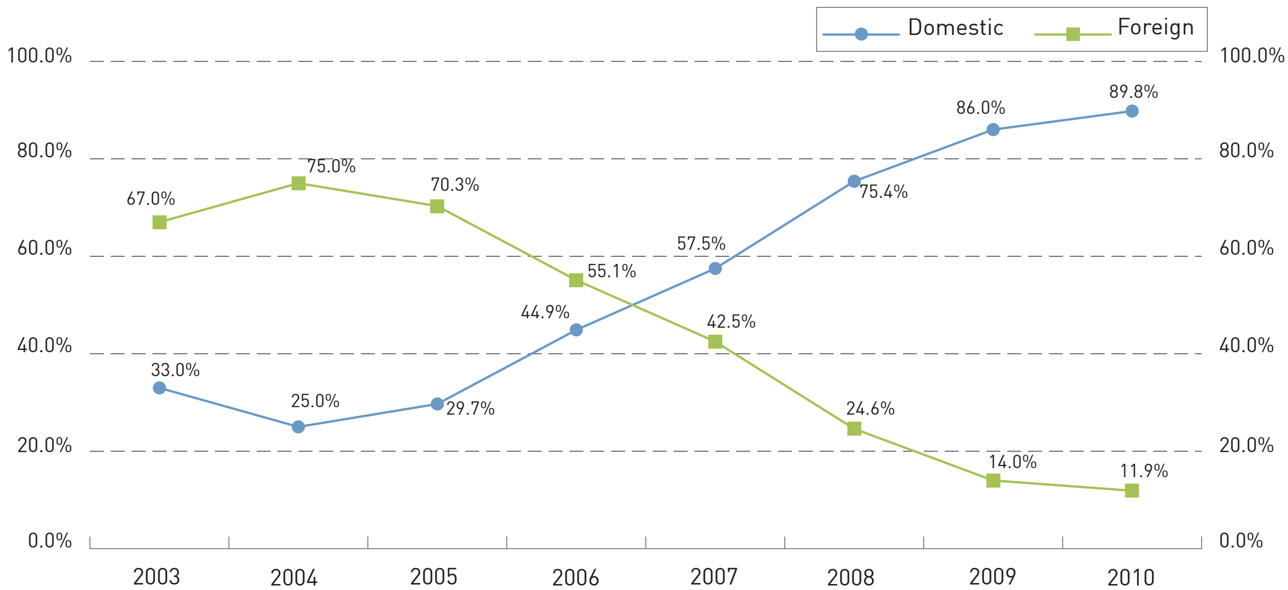
B Discriminatory procurement policies

China has been progressively restricting access to its public procurement markets for foreign companies in order to favour domestic companies. On a global scale, European companies are highly competitive in procurement markets, for example in public transport, complex infrastructures, medical devices or green technologies. The Chinese procurement market is among the largest in the world, and European companies are eager to contribute to its development. However, this is a challenge in practice as the following example from the clean energy industry demonstrates:

Example — Wind Industry in China

In June 2009, China issued an edict affirming that "Government investment projects should buy domestically made products unless products or services cannot be obtained in reasonable commercial conditions in China". Consequently, when the Chinese government took bids for 25 large contracts to supply wind turbines, every contract was won by one of seven domestic companies, including several companies that had no prior experience in building a turbine. The six multinationals that submitted bids were disqualified on various technical grounds within three days of bidding for the wind farm contracts. Some of the European turbine manufacturers had already built factories in China in order to comply with the country's requirement that turbines contain 70 percent local content. In addition, the Chinese government banned virtually any installation of wind turbines with a capacity of less than 1000 kilowatts – excluding 850-kilowatt designs, a popular size for European manufacturers. **Chart 4** illustrates the changing market share of clean energy companies in China.

Chart 4 China foreign suppliers of wind energy
Source: 2010 China Wind Energy Association Annual Report



Restricting market access undermines competition and does not help the country to build up a sustainable innovation capacity. Restricting public procurement limits access of the government to best quality and price available in the market. In order to achieve this, more clarity is needed on the content and applicability of legislation (interaction between Government Procurement Law and Bidding Law), and what would be covered by China's still pending accession to the plurilateral Government Procurement Agreement (GPA). The revised Chinese GPA offer of 2010 was better than the initial offer but falls short in comparison to the commitments made by other GPA members:

- the threshold for open tenders would remain about 50% higher than other GPA members and the coverage would be very restricted;
- sub-central government entities, state-owned enterprises and crucial parts of the construction sector would not be covered. For instance, China has excluded those construction segments in which European contractors are competitive, such as civil engineering works;
- China is proposing very long transition periods.

Moreover, approximately 90% of the Chinese procurement market would be excluded from the GPA coverage due to the fact that almost all public works in China are implemented by a separate public entity – usually a special purpose SOE – for which the Bidding Law, and not the Government Procurement Law applies:

Table 6 Overview of China's procurement rules
Source: European Union Chamber of Commerce in China, Public Procurement Study: European Business Experiences Competing for Public Contracts in China

	Government Procurement Law	Bidding Law
Estimated market value	**700 billion RMB**	**Approximately 7 trillion RMB**
Typical Projects Covered	Mainly construction and maintenance of government buildings, railway, information technology, office equipment, government car fleets. purchases of services for ministerial buildings and non-commercial government entities (not SOE).	Mainly SOEs; renewable energy, power generation and supply, sewage, water supply and public transportation, most large construction projects e.g. all 2008 Olympic construction projects, highways.
Currently covered by WTO GPA negotiations	YES	SOEs were excluded from the scope of GPA coverage. Some (low-value) government entities have been included, but these only procure goods and services for their own use.

RECOMMENDATION
Establish a level playing field through GPA accession

China's rapid accession the WTO's GPA should be a priority ten years after it has joined the WTO. The EU should encourage China to make a substantial new GPA offer whose commitments and coverage compares favourably with current GPA members.

C Subsidies

China's WTO accession commitments were quite clear as it committed to eliminate all subsidies policies that would be inconsistent with existing WTO rules. Yet, there are concerns that China is still using prohibited subsidy schemes in a large number of sectors. Subsidies may take different forms, such as direct financial contributions, below market financial conditions or in-kind support.

A recent phenomenon has been the submission of very low tenders from Chinese state-owned construction companies in connection with EU-financed construction projects, which suggest the existence of public subsidies.

Paradoxically, the EU State aid rules only apply to the EU Internal Market and, therefore, are not applicable to subsidies granted by other countries. There are no multilateral disciplines for subsidies in the area of services comparable to the WTO Agreement on Subsidies and Countervailing Measures or the Agreement on Antidumping which apply only to trade in goods. Consequently European services suppliers cannot launch an anti-subsidy defence case. While discussions in the WTO to introduce disciplines to address trade-distorting subsidies have been underway for more than a decade, there are limited prospects for coming to a multilateral agreement in the near future.

If China is a big user of subsidies, why are there so few anti-subsidy cases against China?

The EU applied its first anti-subsidy measures against China on 14 May 2011 on coated fine paper. Although this was a significant achievement, it is unlikely to lead to a raft of new anti-subsidy cases for three reasons:

- Anti-subsidy complaints are more politically charged than anti-dumping cases because industries target a foreign government whereas in anti-dumping cases, they target a competitor. The fear of retaliation is much greater. In fact, in the coated fine paper case, China immediately retaliated against the EU (legal action) with the application of anti-dumping duties against EU potato starch exports.

- Anti-subsidy cases are difficult to build even when there is ample evidence of subsidisation notably because it is challenging to assess the actual impact of the subsidies on export prices. As a result, anti-subsidy measures tend to be very low, thereby limiting their effectiveness in shielding industry from unfair competition. In the fine coated paper case, the industry had to combine the anti-subsidy case with an anti-dumping case to obtain an economically meaningful result.

- Subsidies are granted by all levels of government (national, provincial and local) and with a country of the size of China, identifying market-distorting measures is an enormous challenge.

Although the anti-subsidy policy instrument is challenging, this is an efficient way to build up clear evidence that China is massively subsidising its industry – which is in contradiction with WTO rules.

RECOMMENDATION
Challenge chinese subsidies at bilateral and multilateral level

The EU should take every opportunity to pressure China to reduce subsidies to industry, in particular energy intensive sectors, which provokes trade frictions, environmental damage and increased competition over scarce energy resources. This includes:

- Anti-subsidy complaints by industry when justified. This will build up evidence for the WTO to ban Chinese subsidies outright. However, anti-dumping will continue to be the economic instrument to counterbalance subsidies over the short term for industry.
- Ex-officio anti-subsidy cases against China to counter subsidies and build up evidence for WTO cases.
- WTO cases challenging subsidies that distort trade.

On a parallel track, the EU should push for multilateral rules on competition policy, state aid and subsidies. Such rules would be a logical complement to trade and investment liberalisation, as markets opened by WTO disciplines can be closed off to foreign competition by anti-competitive practices.

D Enhance legal certainty and improve business consultation

Many foreign companies struggle with the Chinese regulatory environment as most policies and regulations are not clear and sometimes even applied retroactively. This gives government entities a lot of discretion, leads to inefficiencies, legal uncertainty and increased cost for business. They are contrary to a level playing field, allow public officials to implement preferential policies for domestic companies, and – most worryingly – also breed corruption.

There have been a number of cases where legislation has been promulgated without properly seeking input from stakeholders, notably industry. The EU and China could also benefit a lot from a closer involvement of representative private business organisations. Those could serve as facilitators by jointly examining common challenges and discussing potential ways forward. The overall political and business climate could be further improved through an open and frank dialogue between China and the EU, both at political and business level.

Transparency is an important part of doing business, and constructive criticism of public policies contributes favourably to improve the overall regulatory regime. In that context, taking retaliatory measures as a consequence of a specific political or business initiative will not improve the bilateral relationship. It will have exactly the opposite effect.

RECOMMENDATION
China should enhance transparency and predictability

Integrity and credibility are the keys for healthy business development, together with transparency and certainty for business. Therefore laws and regulations must be clear and fully enforced everywhere in a non-discriminatory manner. A real cross-sectoral dialogue between the EU and Chinese private sector representatives would be beneficial in order to enhance business-to-business cooperation. BUSINESSEUROPE could organise such a dialogue which should include both a Chinese horizontal business federation as well as the major sectoral federations on the EU and Chinese side.

2 CONDITIONAL MARKET ACCESS

With €5.3 billion of EU inward investment 2009, the commitment of European companies in China is high. But access to the Chinese market often has a price: the transfer of technology. Increasing pressure is placed on EU companies to transfer key technologies on non-commercial terms. China is still considered to be one of the most restrictive countries for foreign investment in the world as overcoming Chinese market access barriers often requires a substantial technology payment with long-term risks for EU industry. This also prevents China from building up a sustainable innovation capacity via open and fair competition.

A Foreign ownership restrictions

China's policy of attracting foreign direct investment (FDI) would be enhanced further by eliminating state practices that distort investment strategies of European companies.

The State-owned Assets Supervision and Administration Commission of the State Council (SASAC) holds a controlling stake of the State in industries vital for the national economy. **Table 7** shows the sectors where restrictions are largely imposed in China.

Table 7 Chinese strategic sectors
Source: Brussels Institute of Contemporary China Studies: Chinese Strategic state-owned enterprises and ownership control, Mikael Mattlin

Categories	Industries included	Ownership objective	Number
Strategic & key industries	Defence, power generation and distribution, telecom, oil & petrochemical, coal, civil aviation.	Maintaining 100% state ownership or absolute control; increasing state-owned assets in these industries.	40
Basic & pillar industries	Machinery, auto, IT, construction, steel, base metals, chemicals, land surveying, R&D.	Absolute or conditional relative controlling stake; enhancing the influence of state ownership even as the ownership share is reduced where appropriate.	60
Other industries	Trading, investment, medicine, construction materials, agriculture, geological exploration.	Maintaining necessary influence by controlling stakes in key companies; in non-key companies state ownership will be clearly reduced.	40

In strategic and key industries there is no possibility for foreign companies to establish an independent foothold in the Chinese market. Those sectors remain completely dominated by Chinese SOEs. Strong ownership control is also maintained in basic and pillar industries, with strict conditions that require foreign companies to establish joint ventures with Chinese companies. For example, foreign investors are only allowed to hold a minority share in steel which is considered as an industry related to "national security".

Even if there are different limits for ownership and control depending on their classification, China's government can influence almost all sectors of its economy through foreign investment restrictions. These obstacles hamper both companies coming to China as well as those expanding already existing activities. Moreover, they do not make sense in a globalised economy.

RECOMMENDATION
Allow restrictions only for national defence

China should reduce its list of strategic sectors and open sectors that are not directly relevant for Chinese national security to foreign investment and competition. China should also remove the minority shareholding requirements for all but strategic industries limited to national defence. Foreign investment should receive national treatment, and be allowed to fully participate in mergers and acquisitions.

B Transfer of technology and confidential information

The transfer of technological know-how is a key element of a business relationship. China's aim to attract the latest technologies to spur its economic development is understandable. However, when investing in China, EU companies need to comply with a series of regulations that seek to disclose very sensitive commercial and technological information to Chinese research institutes and companies. This also relates to trade secrets which often cover some of a firm's most valuable assets (e.g. the formula for a successful drink or a state of the art manufacturing process).

The loss of know-how or trade secrets is invariably harming a company's business, its innovation strategy and its R&D efforts. Therefore, technology transfer can only be a basis for business when it is carried out voluntarily on commercial terms and with a self-selected partner. Chinese laws and practices often go much further than this.

Technology transfer obligations seriously block market entry and business expansion for foreign companies in China, making it difficult for companies to conduct mergers and acquisitions and putting them in a disadvantageous position when negotiating technology transfer and IPR protection with Chinese partners.

Example **Registering a patent-related agreement**

The revised patent law requires companies filing patent applications to comply with China's Ministry of Commerce (MOFCOM) Technology Import-Export administrative regulations. Since 2009 they require registration with MOFCOM of most technology transfer and license agreements, including patent assignments, assignment of rights to apply for patents, and patent licences. Although the rules do not specify penalties for non-compliance, a registration certificate from MOFCOM is necessary to engage in various commercial activities requiring government authorisation, including foreign exchange and customs importation. Consequently, a failure to register a patent-related agreement in a timely manner could significantly impede commercialisation efforts.

China would also benefit from a competitive funding system to encourage foreign companies' R&D activities. Contrary to practices in the EU, most R&D programmes are restricted to Chinese companies only.

All enterprises registered in China should be eligible to apply for the R&D funding programs with equal rights and the innovation ability as the only criteria for evaluation.

RECOMMENDATION
Allow the protection of confidential information

China should eliminate unfair practices and regulations which require foreign firms to transfer technology, be it by law or by political and/or commercial pressure. Existing rules inhibit rather than facilitate the development and diffusion of key technologies in the Chinese market. A better definition of the minimum information to be provided for project approval and document filing, as well as greater transparency in the selection of experts involved in project assessment, would improve confidence in the protection of sectoral proprietary information.

C Restrictions on services

The services sector, which now accounts for 40% of GDP, is increasingly important for China. Compared to other emerging countries, China made considerable commitments for liberalisation in services sectors upon accession to the WTO in 2001. These market openings were both realised via multilateral commitments or via bilateral agreements, as in the very positive example of the maritime sector. China also tabled an interesting offer in other services sectors in the Doha round negotiations. However, services markets remain heavily regulated and trade in services is restricted. Burdensome capital and joint venture requirements continue to act as deterrents to entering the Chinese services market, effectively nullifying the market opening effects of China's WTO commitments.

Below are some prime sectors where further liberalisation efforts are essential:

- Telecommunications;
- Legal services;
- Postal and courier services;
- Construction;
- Environmental services;
- Insurance and insurance related services;
- Banking, securities and other financial services;
- Architectural and construction services.

These restrictions force EU companies to cooperate with Chinese companies in joint ventures and to transfer their know-how. Although it highlights the importance of growth in the services sector, the new 12th Five-Year Plan is unlikely to further open the sector to foreign competition.

RECOMMENDATION
Continue services market opening

The Chinese market should be opened to EU service providers on a non-discriminatory basis in line with the letter and spirit of China's WTO commitments. This will also be beneficial for China as it will lead to gains in competitiveness and efficiency for its economy.

D Chinese Compulsory Certification (CCC) and absence of international standards

Chinese conformity assessment procedures and the Chinese standardisation system constitute a significant challenge for European companies. Work has been done on easing these challenges for many years but, although progress has been made, the current situation is still not satisfactory.

Many products fall directly or indirectly within the scope of the China Compulsory Certification (CCC) scheme and, in order to be granted market access, European companies have to invite Chinese inspectors to their production sites, even if the product meets all technical requirements.

Example **Specific tests required for tyres**

Currently the Chinese CCC system foresees only accepting tyres tested in Chinese laboratories. Due to recent amendments of Chinese Compulsory Certification system regarding tyres, large numbers of manufacturers have to test new tyre types/sizes and re-test old types/sizes. This will certainly lead to bottlenecks in testing tyres for the certification in addition to the risks of technology theft by competitors.

China also often deviates from internationally accepted norms and modifies standards and licensing procedures significantly prior to national absorption. Chinese standards and requirements change rapidly and authorities are increasingly promoting domestic standards that are incompatible with international standards.

At the same time, Chinese companies can usually rely on local testing without the need of external certification to gain access to the European market. This imbalance in trading rights between the EU and China needs to be adjusted.

RECOMMENDATION
Apply international standards

European industry expects the EU and China to work on a level playing field in the area of standards and conformity assessments. The Chinese administration should allow mutual recognition of test results based on international standards having a recognised scientific basis and should not require any additional testing for European products. The leitmotiv should be the principle of 'a product tested once and accepted everywhere'.

3 INNOVATION AND IPR

The biggest challenge from China is the access and ownership of technology. China's objective to move up the value of its products is an understandable and logical consequence of economic development – and a very legitimate objective which deserves support. However, this will require a further improved and well implemented IPR regime which protects companies from the expropriation of technologies.

A Promotion of domestic innovation

There is an increasingly clear trend towards China selecting technologies and products based on the geographical origin of their creation. Since 2006 China has encouraged innovation through preferential treatment for products containing "indigenous" IPR. This discriminates against foreign and Chinese companies of foreign origin and deters them from marketing innovative products in China. The related policies limit the types of products that are developed and used in China and exclude some of the most innovative suppliers, the associated research and development, and resulting innovation benefits to the Chinese market.

"Order 618" on the proposed National Indigenous Innovation Product Accreditation Catalogue for Government Procurement (NIIP) of November 2009 explicitly connects "indigenous innovation" to government procurement. This gave rise to worldwide business opposition as the NIIP would have severely impacted the ability of foreign companies to operate on a level playing field with local companies in China. The new draft regulation, released by the Chinese government on 10 April 2010, as well as recent announcements should give foreign-invested companies in China a better chance to take part in the process. However it will depend how far those are implemented in practice at local level.

To promote the development of intellectual property in China, the Chinese government recently adopted measures to promote the filing of patent applications abroad by reimbursing certain "domestic applicants" for the costs of seeking foreign patent protection. In doing so, the measures go against China's WTO commitments because they accord foreign entities less favourable treatment than comparable domestic entities with regard to the protection of intellectual property.

RECOMMENDATION
Create an open climate for innovation - but not through the National Indigenous Innovation Programme

China should not carry forward the the National Indigenous Innovation Programme (NIIP). Lists or catalogues by definition are counterproductive as they fall out-of-date very quickly, especially in the high-tech sector. Moreover, the core issue, namely how to build up a sustainable innovation capacity via open and fair competition and without restricting market access, remains untouched in the NIIP.

B Compulsory licensing

As part of its National IP Strategy, China has focused on improving its standards-related policies, including regulating "the process of turning a patent into a standard". Unfortunately, proposals made by the Standards Administration of China (SAC) departed significantly from internationally accepted patent policies of other standards organizations, as it would have obliged patent owners to grant a royalty-free license or a license with a royalty substantially below market rates. In 2010, following consultations the China National Institute of Standardization's (CNIS) Disposal Rules for Inclusion of Patents in National Standards (Disposal Rules) have been made more consistent with international rules with the omission of the highly controversial compulsory licensing requirements. However, further alignment with global standards is necessary. For example, infringement of essential patents is based on "commercial feasibility" as opposed to the more customary "technical essentiality". This exposes companies to significant legal risks.

China's patent law and anti-monopoly law provide the government with broad authority to grant compulsory licenses. The relevant Chinese government agencies have yet to clarify the circumstances under which compulsory licenses may be granted. Even though they claim to have no immediate plans to exercise this authority, it leaves companies exposed to legal uncertainty.

RECOMMENDATION
Refrain from compulsory licensing

Export-oriented Chinese industries would be seriously affected by a proliferation of weakened TRIPS provisions. An erosion of intellectual property standards occasioned by the unwarranted use of compulsory licensing worldwide is in no one's interest. Therefore China should refrain from compulsory licensing except in those exceptional circumstances as specifically delineated by TRIPS.

C Enforcement of IPR policies

Although China has made substantial progress in streamlining its intellectual property legislation and efforts to implement WTO/TRIPS rules, effective enforcement of IPR remains very problematic at regional and local levels. The scale of the production of counterfeit and pirated goods inside China remains alarmingly high. In 2010, 85% of the total amount of articles infringing IPR that were seized at EU borders came from China. The proliferation of counterfeit goods is also affecting EU companies on the Chinese market as they may have to compensate Chinese consumers who have unknowingly bought counterfeit goods.

Example | **Product piracy**

Chinese product pirates collected used drums of a European producer, refilled them with their own product of lesser quality and then resold them to Chinese consumers as original EU made material. When these customers complained to the assumed European producer (i.e. original owner of the used drums), costly tests had to be conducted (at the EU producer's expense) to prove that the material was from a different source to avoid reputational damage. Furthermore, due to customer relationship management, the frauds on Chinese customers were partly compensated to avoid lengthy (and uncertain) legal disputes and maintain good relations, again creating extra costs to the EU producer.

The real challenge is that the application of existing IPR laws varies significantly within China. Due to a lack of technically versed judges, the courts in Shanghai and Beijing play a leading role in patent dispute settlements. Outside these urban centres, a high degree of legal uncertainty remains. Enforcing legal rights especially for foreign IP holders remains unpredictable and difficult. Since more than 90% of IPR infringements are disputes between Chinese companies today, Chinese as well as EU companies would benefit from more reliable implementation of Chinese IPR.

RECOMMENDATION
Simplify and enhance IPR implementation and administrative procedures

IP implementation provisions should be more effective by simplifying the burden of proof and by eliminating all pre-conditions to act against counterfeiting. Ensuring that intellectual property legislation is being applied by courts fairly and consistent with international rules could be achieved through sending judicial observers from the European Commission, or a contracted NGO, to monitor the fairness and general tenor of judicial proceedings. The procedures to register Trade Marks and Designs should also be made simpler, faster and more transparent. Finally, China should bring its patent policies in line with international practice by requiring utility patents to include an investigation on novelty and innovativeness.

SECTION 3
CHINA'S PRESENCE AND IMPACT IN EUROPE

The influence the Chinese government is exerting on European companies in China is significant, the impact it has on the European market is considerable as well. The EU has a substantial bilateral trade deficit. China's inward investment to the EU, which amounted to €0.3 billion in 2009 – a level that remains significantly lower than that of other industrialized countries – has grown significantly over the past few years, particularly in strategic areas. Examples of China's presence can be found in the field of public procurement, or investments in companies producing cutting-edge technologies. While increased engagement in Europe from Chinese companies is welcome, such investments must be on fair terms.

A Macroeconomic imbalances

The pegging of the Chinese currency to the US dollar has helped promote Chinese exports and China as an investment destination. However, it has also contributed to global trade and account imbalances. The peg of the Renminbi to a currency basket in 2005 to allow it to float in a corridor was a step forward. However, a more flexible currency regime is essential to rebalance the Chinese economy, reduce reliance on exports and encourage domestic demand.

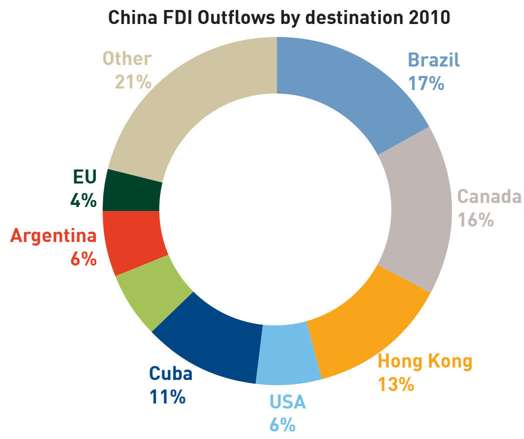
RECOMMENDATION
Support global adjustments to macroeconomic imbalances

China should pursue the Chinese Renminbi's gradual adjustment to market forces, while ensuring that financial stability is preserved. The EU-China High-Level Economic Dialogue and the EU-China macroeconomic dialogue should allow the EU and China to improve mutual understanding and coordination. Moreover, they should develop further cooperation on this issue and on foreign exchange reserve management at bilateral, regional (ASEM) and international levels.

B Increasing Chinese investments

Growing interest in the European market from Chinese companies is positive. It proves that Europe is an attractive and competitive investment destination. Currently relatively small in number, Chinese investments focus on the eastern and southern parts of Europe.

Chart 5 Graphic overview of Chinese investments abroad
Source: European Commission, DG Trade



Such investments must be on fair terms and a level playing field. European companies face unfair competition when Chinese companies are backed-up by subsidies. A number of European governments have expressed concerns about certain types of foreign investment in European industries, particularly from Sovereign Wealth Funds or state-controlled companies. While open flows of both inward and external investment are fundamental to the competitive performance of companies in Europe and of the European economy as a whole, the EU cannot ignore that European companies do not receive a reciprocal level of openness on the Chinese market. China must therefore open its market further to EU investors on a non-discriminatory basis.

Moreover, EU security concerns and risks should by no means be underestimated. While there is no doubt that Europe needs to act with caution, the EU must also reflect on the ways to achieve a level playing field for investment with major economic powers like China. With its new competence over foreign direct investment, it is incumbent on the EU to engage in a thorough discussion with BUSINESSEUROPE on this important challenge taking into consideration that other major economies like the US, Canada and China resort to foreign investment reviews in their legislation.

RECOMMENDATION

Negotiate a bilateral investment agreement

The EU and China should negotiate an ambitious bilateral investment agreement which would provide legal certainty for both sides. Provisions should include a broad definition of investment, covering pre- and post-establishment for all sectors of business. Furthermore, to guarantee the agreement's effectiveness, relevant enforcement mechanisms such as an investor-to-state dispute settlement system as well as a mediation mechanism for minor complaints should be incorporated.

C Restrictions on access to raw materials

A steady and undistorted supply of raw materials is crucial for the functioning of the European economy. China is following an elaborate policy mix to secure extensive positions in the markets for critical raw materials such as rare earths, minerals or cotton. A key feature of this policy is Chinese export restrictions on essential industrial raw materials. Because of China's particularly strong position as a global supplier, these restrictions not only increase global prices for these materials but also distort worldwide competition for downstream industries.

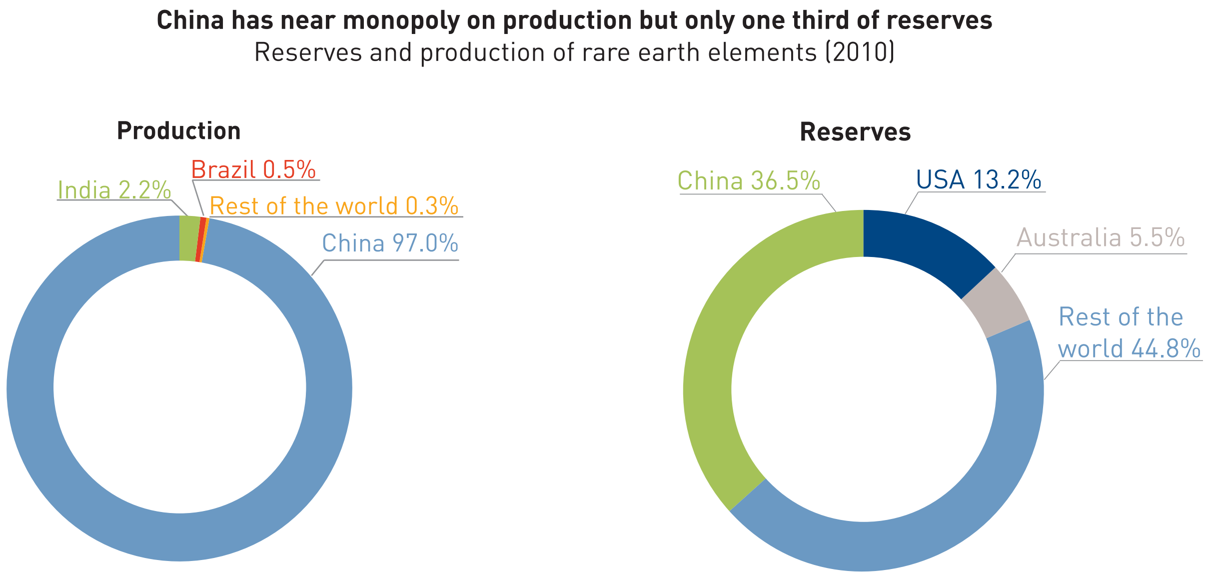
Example — The WTO condemns Chinese raw materials restrictions

On 5 July 2011 a WTO Dispute Settlement Panel determined that Chinese export duties on yellow phosphorous, bauxite, coke, fluorspar, magnesium, manganese, silicon metal, silicon carbide and zinc were incompatible with WTO rules because they exceeded commitments made in China's Accession Protocol. Similarly, export restrictions (e.g. quotas, licences, minimum export prices) were deemed incompatible with general WTO provisions under GATT article XI. In all cases, the Panel found that the export restrictions imposed by China could not be justified under possible WTO exceptions. This panel decision demonstrates that Chinese export restriction policies are trade distortions and should be removed.

Moreover, industries processing these raw materials in China have access to cheaper inputs than their competitors abroad, which amounts to a subsidy for the domestic industry. China often provides local industry with the benefit of prices well below the market average. For raw materials where China is a world dominant supplier, export taxes and quotas suffice to create dual-pricing of inputs to the benefit of the Chinese operators. This sourcing advantage has a very significant price impact, for instance in the case of some rare earth metals it is a factor of 10. Moreover, the fact that the purchasing of raw materials is handled through SOEs enables the Chinese government to directly interfere on the prices.

There are increasing concerns that China is pursuing an aggressive policy, including strategic investments, to secure and gain control over critical raw materials. Particularly critical are recyclable materials and so-called high-tech raw materials like rare earths, gallium and tungsten that are subject to high import dependency in Europe and currently lack substitutes. These raw materials are essential to the implementation of sophisticated technologies and the development of technological solutions for the low-carbon economy, such as the new generation of wind-powered turbines for off-shore parks or compact fluorescent light bulbs. On these materiels, China has a quasi-monopolistic position on global production due to its favourable extraction costs.

Chart 6 China's dominant position on rare earths
Source: DI Global Benchmark Report, 2011



BUSINESSEUROPE was alarmed by China's decision in July 2010 to reduce export quotas for rare earths while maintaining availability for locally owned industrial consumers of rare earths in China.

While China's efforts to reform its mining sector are recognised, this unexpected situation has negative impacts for EU industry, such as strong price increases and delivery shortages.

RECOMMENDATION
Reinforce existing WTO provisions and implement a strategic raw materials policy

The EU and China should cooperate to ensure consistent raw materials provisions at multilateral level: where Article XI paragraph 1 of WTO-GATT establishes a general ban on export prohibitions / restrictions, paragraph 2 allows for temporary measures in case of some specific conditions. The EU should strive for a reinforcement of this provision by limiting the exception of paragraph 2. A special provision should also be included to prevent government policies to subsidise domestic industries by artificially manipulating prices. In addition, the EU should implement the "Raw Materials Initiative" which sets out a cross-cutting strategy to address distortions and to secure access to raw materials. In this respect, it is key to require compliance with WTO rules and commitments from global supplying countries.

D Access to European procurement markets

The EU commitment to openess in public procurement is a key part of the EU's Single Market programme, and of the EU's trade policy, both through the WTO Government Procurement Agreement (GPA) and procurement chapters in Free-Trade Agreements (FTAs). This combination of international commitments and Single Market rules has created a European market that is widely open to international competition.

However, some high-profile public procurement contracts won by non-EU bidders in Europe or cases where EU companies were excluded from tenders in third countries have highlighted an imbalance. The recent participation of Chinese companies in EU tenders operating at costs far below the possibilities of the market suggests they are operating with subsidies. This is not acceptable as competitors do not bid on a level playing field.

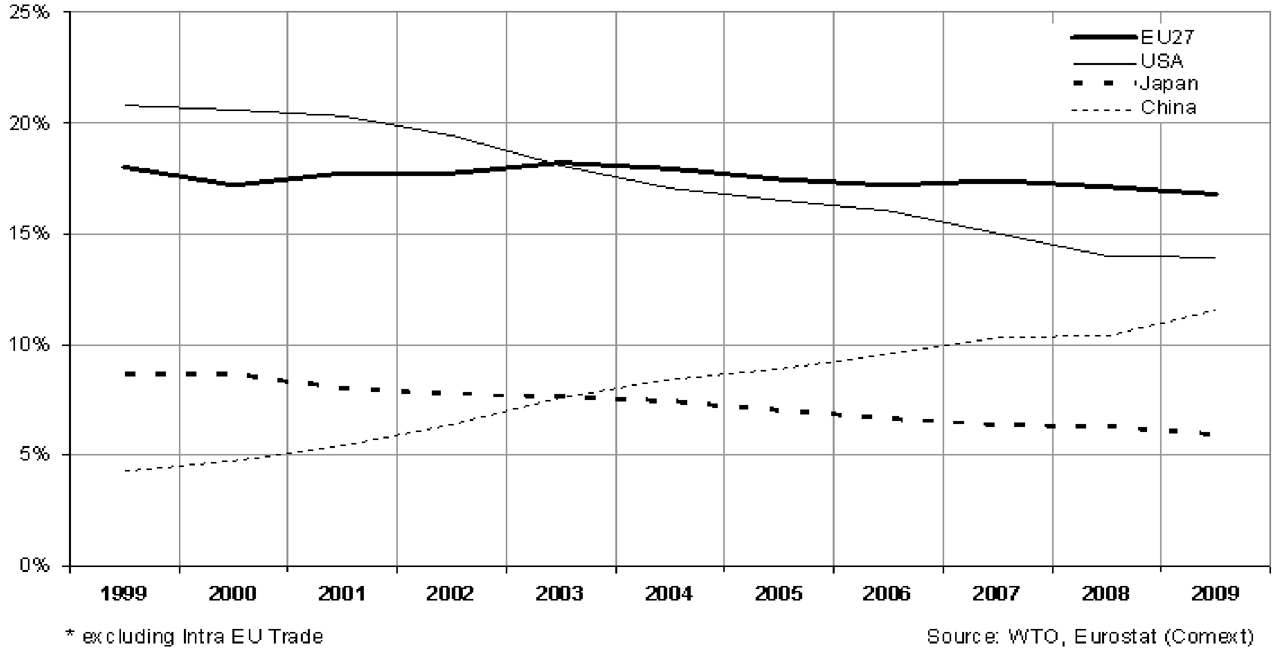
RECOMMENDATION
Foster mutual openness in public procurement markets

EU State aid rules only apply to the EU Internal Market and, therefore, are not applicable to subsidies granted by other countries. Nor are there multilateral disciplines for subsidies in the area of services. This opens the door for "abnormally low tenders" from Chinese state-owned companies within the EU Internal Market. If this issue cannot be agreed upon on the multilateral level, then the EU should consider taking action on the EU level, for instance by modifying Art. 55 of the EU Directive 2004/18 to the extent that third-country bidders have to prove that they are not benefitting from state subsidies whenever they present an abnormally low bid. In addition, given considerable uncertainties as well as diverging practices about contents and scope of WTO/GPA law and diverging practices throughout the EU member states, extensive information for contracting authorities and EU companies is necessary. The current reflection at EU level on mutual openness in procurement will have to consider ways to deal with countries that manifestly exclude EU companies from their markets. It will notably have to consider whether carefully targeted restrictions on access to parts of the EU procurement market might be useful to encourage trading partners like China to offer reciprocal market opening.

SECTION 4
A MAJOR COMPETITOR ON THIRD MARKETS

Over the last 10 years, China has continuously increased its share of world trade, as ***Chart 7*** *demonstrates:*

Chart 7 Share of EU 27, US, Japan and China in world trade in goods
Source: Communication from the European Commission: Trade, Growth and World Affairs; Trade policy as a core component of the EU's 2020 strategy



In addition to this steady increase of Chinese market share, there is also a clear link between China's development policies and its state objectives. A look into the policies towards third countries demonstrates how China is strategically pursuing its economic interests. This becomes evident notably in the area of access to raw materials and energy. European companies moreover are exposed to unfair competition as China is not bound by OECD rules.

A Unfair export promotion policies

Chinese trade promotion policies sometimes lead to the subsidisation of Chinese exports on global markets. The Export-Import Bank of China (Exim) provides Chinese Government Concessional Loan and Preferential Export Buyer's Credit with the purpose to finance the procurement of Chinese mechanical, electronic products, complete sets of equipment, technology and service and other goods by the borrowing country. This is further elaborated in the criteria where (a) Chinese companies must be selected as the project contractor; (b) in procurement, priority shall be given to equipment, materials, technology or services from China. To benefit from these loans, no less than 50% of total procurement must be made in China.

EU exporters have experienced problems in export credit competition with China in a wide range of emerging and developing country markets. A broad range of industry sectors have been confronted with unfair competition, notably in infrastructure projects, energy, communication, transportation, but also in other sectors (cement, steel, machinery, agricultural equipment, metalworking, social infrastructure, etc).

Chinese Export Credit Agencies offer much more favourable trade finance conditions than Export Credit Agencies in the EU through:

- lower insurance premiums and longer repayment terms than are authorised under the OECD Arrangement;
- very favourable – low or "subsidised" – interests rates;
- a "flexible" approach in the application of Chinese export credit conditions, adapting them to the respective project requirements.

China is also providing targeted incentives by rebating VAT on exports in a differentiated manner along a product value chain or amongst manufactured products. Consequently, EU industry is confronted with increased competition on these product markets, both in the EU and in third countries. In addition the way China is adjusting VAT on exports blurs market signals for investment, leading to production overcapacity in certain products. The policy is also carried out in an unpredictable manner which creates considerable business uncertainty.

RECOMMENDATION

Sign up to OECD rules on export credits and align the VAT system to international practice

China should adhere to the OECD Arrangement on Export Credits. A global weakening of these disciplines cannot be in China's interest as it will lead to a dangerous "race to the bottom", with states giving credits below market terms and undermining their efforts to carry out sustainable fiscal policies. Competition should take place between bidders and not between export credit agencies. BUSINESSEUROPE will further study what kind of approaches could be taken in order to tackle this problem.

The alignment of the Chinese VAT system to international VAT practice would prevent VAT to be used as a means of subsidisation on export and allow avoiding that wrong signals are given to Chinese operators.

B Development aid linked to strategic objectives

China has become a major donor in the field of international development, and links aid very much to its strategic economic objectives. In recent years, China made many raw material investments through SOEs and Sovereign Wealth Funds in a number of African countries.

China pursues a strict "business only" Development Cooperation policy and does not interfere in domestic affairs of the recipient countries. This gives China an edge in securing access to raw materials. Favourable financing conditions provided through (i) grants; (ii) interest-free loans; and (iii) concessionary loans are also a special feature of Chinese development policies.

European companies cannot benefit from comparable financing conditions in the EU and even when they are established in China under Chinese law, they are not eligible for concessionary loans.

As recipient countries of Chinese development aid are encouraged to use Chinese suppliers, these policies lead to a de facto exclusion of foreign competitors, contrary to EU development policy practices.

RECOMMENDATION

Link up EU development and commercial policies

The EU has significant resources to facilitate partnerships and cooperation with developing countries. It should lift restrictions on development and technical assistance funds that prohibit support for EU interests and EU business. In addition, the EU should reach out to large recipients of development aid (the EU and Member States provide roughly €50 billion/year – the EU €7.5 billion alone) in cases of competition with Chinese companies.

C Ethical behaviour

The vast majority of European companies conducting business in developing countries bring benefits to the economy and society, in terms of employment, providing goods and services, and supplying contracts to local businesses, etc.

European companies also comply with obligations under the OECD convention on bribery and corruption and the principles set out by the OECD Guidelines for Multinational Enterprises. Chinese SOEs face less public scrutiny to implement ethical, environmental and social standards or Corporate Social Responsibility and are not bound by the OECD disciplines in their investment decisions.

RECOMMENDATION

Apply OECD principles but refrain from unilateral rules

European companies consider their stakeholders when defining and undertaking their business activities. Many companies also work with stakeholders to contribute to dealing with major challenges, for example energy efficiency, supply chain management or human rights. A business-driven approach to ethical behaviour reflects reality. The Extractive Industries Transparency Initiative (EITI) is a positive example where business, policy-makers and civil society jointly work for the respect and implementation of global standards. The EU should push China to respect OECD disciplines and become member of EITI-like initiatives, and refrain from pursuing unilateral policies which might put EU companies at a disadvantage.

SECTION 5
EU-CHINA COOPERATION - FROM DIALOGUE TO RESULTS

A A strategic partner that will redefine the global economy

On 16 September 2010 the European Council agreed on the need for strategic partnerships with the EU's main economic partners.

China is without a doubt a strategic partner of major importance for the EU. The EU and China already have a highly structured system of bilateral dialogues in place ranging from Political Summits to more technical meetings.

Two meetings are of particularly significance for the business community:

- The annual EU-China Summit is the paramount political meeting between the two economies. The Summits are led by the Chinese Prime Minister and, for the EU, by the President of the European Council and the President of the European Commission. EU-China Summits cover a wide agenda of issues but economic issues dominate.
- The High Level Economic and Trade Dialogue (HED), with the EU Trade Commissioner and a Chinese Vice-Premier in the lead, deals with EU-China trade relations, investment and economic cooperation. It aims to resolve market access and intellectual property rights protection problems.

While we can commend the EU and China for putting in place an extensive network of dialogues, we are concerned about the slow progress across a wide variety of economic policy issues. The output of this strategic relationship has to be developed further.

European Council Conclusions on strategic partnership:

The European Union's strategic partnerships with key players in the world (...) will only work if these partnerships are two-way streets based on mutual interests and benefits and on the recognition that all actors have rights as well as duties. The full participation of emerging economies in the international system should allow its benefits to be spread in a balanced manner and its responsibilities to be shared evenly.

The European Union should actively pursue its strategic interests, including as regards the promotion of bilateral trade, market access for goods and services and investment conditions; the protection of intellectual property rights and the opening up of public procurement markets; stronger discipline in the field of export subsidies; and the dialogue on exchange rate policies.

B Some weaknesses of the EU's policy towards China

Although the EU has had significant successes in translating its commercial weight in international trade negotiations, it has had difficulty influencing international affairs outside of trade negotiations. In addition, it is rare for the EU and China to align their positions even in areas where the EU and China have common cause for cooperation, like in the WTO Doha Round due to their significant export interests. Regrettably, these disagreements are mirrored at the bilateral level as well. The EU's internal divisions and subsequent inability to deliver on a coherent strategy compound this challenge.

As the EU Council on Foreign Relations points out *"EU member states have weakened Europe collectively and each member state individually when they have faced difficulties in their bilateral relations with China".* (...) *Europe was divided along two fault lines within Europe: firstly, a divide between free traders and those who were more accommodationist (...)" (John Fox, and Francois Godement.* A Power Audit of EU-China Relations. The European Council on Foreign Relations, 2009).

While we believe that the EU can benefit from well-functioning bilateral relations of China at member state level, the divisions between EU member states can have negative consequences for business. For example, China has retaliated against individual EU member states in relation to political issues or activities in the EU by severing diplomatic relations, excluding companies from public procurement projects or withdrawing business licences in China. The absence of an EU reaction to this has increased pressure on EU member states to compromise on important values and left European companies vulnerable to discriminatory treatment.

At a more technical level, the Chinese government has rarely refrained from intervening directly in the internal decision-making of the EU. In sensitive anti-dumping areas, like the "shoes" case, the Chinese government has pursued very transparent lobby strategies to influence swing vote member states to vote against dumping duties. China has also lobbied industries with no direct interest in anti-dumping cases to persuade them to actively advocate against them.

Similar Chinese lobbying strategies have been used to try to prevent the EU from building up evidence for WTO trade disputes with China. Even BUSINESSEUROPE has been the target of such action.

Chinese lobbying is legitimate unless it is accompanied by threats of economic retaliation against the business communities or governments. When faced will undue pressure, EU should actively counter direct interventions in its internal affairs by a third country government. EU passivity will confirm the Chinese in their belief that the best strategy toward the EU is to divide and rule through open threats to our interests. We must ponder whether it is in the EU's interests to allow this kind of behaviour to continue. We should also underline that it is very difficult for European companies to resist Chinese pressure. Companies and business federations need to join forces to shield companies from such risks and to stand up and defend free market rules and principles.

RECOMMENDATION
Stand up to threats/retaliation and prevent interference in domestic affairs

a React systematically to threats and retaliation by applying the three musketeers rule. If one EU member state or major interest is threatened or retaliated against, all EU member states will react as one.

b Prevent interference in internal EU decision-making processes by shutting down opportunities for interference (i.e. in anti-dumping) and by non-interference rules/votes in Council decision-making.

c Business should stand up for its rights more forcefully in dealing with problems in China. Business federations like BUSINESSEUROPE should be given a mandate to defend free market rules with appropriate capacities.

C The way forward: for a mature relationship with China

Overall, BUSINESSEUROPE calls for a mature relationship with China based on open and constructive engagement from both sides. Naturally, besides many common interests there are a number of issues where positions differ. Both sides have the right to defend their interests in a strong way. This is a normal feature in the relations between any countries across the world.

However, strict abidance to the rule of law and international agreements, non-discrimination and the existence of a level playing field must be the basis for all potential action to push economic interests. Disagreements should be dealt with in a spirit of cooperation and transparency, and take account of the economic interests of both sides. Threats, retaliation, or other unjustified measures run counter to such an objective, and will hamper both possible common solution as well the establishment of close and long-lasting economic and political ties.

The EU, China and all other international actors rely on partnerships; these only work well if they are beneficial to all parties involved.

The EU and China must find a permanent solution to the problem of protection and transfer of technologies on non-commerical terms. It is not acceptable when companies are forced to make their know-how and business secrets available to potential competitors.

A continuation of current discriminatory policies in China will else put some serious risks over the development of closer economic and political bilateral relations.

The European Union must better prioritise its interests and use its leverage more effectively. For this purpose EU member states first have to define a common strategy and identify EU priorities for the relationship with China. In our view, the EU-China High-Level Economic Dialogue (HED) has the potential to develop a clear set of economic priorities, to drive economic cooperation forward and to tackle irritants to trade and investment. But it needs to set precise targets to avoid becoming an annual bureaucratic exercise without results. Clear mandates from EU member states in consultation with the Parliament's International Trade Committee should give greater legitimacy and negotiators' more room for manoeuvre. Close involvement of business is essential to advance economic issues.

Beyond dialogue, it is important to structure EU-China economic relations around the negotiation of binding international agreements. The EU should focus on high level bilateral meetings like the Political Summits to advance bilateral and multilateral agreements that will promote a more rules based trade and investment relationship.

Over the short term, three key international agreements are of direct and immediate concern.

a China's accession to the WTO Government Procurement Agreement (GPA) must be a priority for the EU. China needs to accelerate the negotiations, notably by improving its offer to the level of the other major economies in the GPA with no exceptions. It must be made clear to China that the failure to advance this negotiation will expose its companies to serious limitations in trying to penetrate the EU market in future.

b China must be encouraged to take a bolder position in the WTO Doha Round negotiations. Considering China's massive expansion of export market share over the last 15 years, it is untenable that China does not sign up to more ambitious market access commitments – notably in key sectors: chemicals, machinery. Moreover, China should take up a more pro-active role in the establishment of stronger global trade rules.

c The EU and China should start negotiations on a bilateral investment agreement covering both pre- and post-establishment rules. By engaging proactively on this issue, the EU and China will work to keep their markets open, to progress on technological cooperation and to deepen business ties across our economies.

Finally, these policies need to be closely coordinated with like-minded countries that pursue similar objectives. China is sensitive to international consensus and coordinated actions involving several States have more chance to succeed than unilateral measures. The case of China's indigenous innovation policies is a good example, as coordinated EU-US action led to a softening of the contentious pieces of legislation.

RECOMMENDATION
Re-draft the EU-China diplomatic strategy

a Use the High Level Economic Dialogue to define an EU mandate for bilateral discussions with China on trade issues.
b Use the Political Summits and other highest level meetings to advance key international negotiations.
c Closely coordinate with major partners to tackle common challenges in China.

BUSINESSEUROPE

MEMBERS ARE 41 LEADING
NATIONAL BUSINESS FEDERATIONS
IN 35 EUROPEAN COUNTRIES

Austria	Belgium	Bulgaria	Croatia	Cyprus	Czech Republic
Denmark	Denmark	Estonia	Finland	France	Germany
Germany	Greece	Hungary	Iceland	Iceland	Ireland
Italy	Latvia	Lithuania	Luxembourg	Malta	Montenegro
Norway	Poland	Portugal	Portugal	Rep. of San Marino	Romania
Serbia	Slovak Republic	Slovenia	Spain	Sweden	Switzerland
Switzerland	The Netherlands	Turkey	Turkey	United Kingdom	

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