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POLICY BRIEF

THE SCRAMBLE FOR EUROPE

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SUMMARY

A kind of "scramble for Europe" is now taking place as China purchases European government debt, invests in European companies and exploits Europe's open market for public procurement. Crisis-hit Europe's need for short-term cash is allowing China not just to strike cut-price deals but also to play off member states against each other and against their own collective interests – replicating a strategy it has already used in the developing world. The expansion of China's presence in Europe is creating new fault lines within Europe and making it much harder to implement the more coordinated and tougher strategy towards China that the EU was beginning to develop. As Europeans compete with each other for Chinese business, they are reducing their chances of collectively negotiating reciprocal access to Chinese markets.

This brief argues that Europeans should not blame China for taking the opportunity to expand its economic foothold inside Europe and leverage its financial and commercial influence with cash-strapped member states. Nor should they resort to protectionism. Instead, they should unify around their collective interests and take steps to create a rules-based and level playing field on which European firms are able to compete in China in the same way that Chinese companies can in Europe. In particular, they should create a coordinated system for government debt purchases and a system for vetting direct investment, and encourage fair competition in public procurement.

China is buying up Europe. Its automobile manufacturers have bought MG and Volvo and taken a life-saving stake in Saab. Its transportation firms are acquiring, leasing or managing harbours, airports, and logistical and assembly bases across the continent. Its development bank is financing projects in Europe's periphery much like it does in Africa. Its purchases of public debt are anxiously sought by deficit-ridden EU member states. In fact, it uses the prospect of these bond purchases as part of its own public diplomacy. In the next wave of public austerity in Europe, its sovereign funds and public or quasi-public firms will be able to shop around for more deals on everything from public utilities to valuable international assets held by the weaker European economies. Once a large but distant trade partner, China is now also a powerful actor within Europe itself.

In fact, a kind of "scramble for Europe" is now taking place. Of course, China is not colonising Europe as Europe colonised Africa at the end of the nineteenth century. Europe is not a source of natural resources as Africa was. Rather, it is often advanced technology in which China is interested when it acquires European companies. Moreover, Europe needs China and welcomes the Chinese presence. But crisis-hit Europe's need for short-term cash in order to boost market confidence in government debt, to save companies and thus jobs, and to save money on infrastructure projects is allowing Chinese companies not just to strike cut-price deals but also to play off member states against each other and against their own collective interests – replicating a strategy China has already used in the developing world.

This expansion of China's presence in Europe comes just as the EU was beginning to develop a more coordinated and tougher strategy towards China. But the effects of the economic crisis are now fracturing Europe's embryonic unity and making it much harder to implement this new approach. In particular, as China becomes a major financial, investment and public provider for Europe, it leaves the Europeans little leverage to improve their own access to these very same sectors in China, which are mostly closed or controlled. In short, as Europeans compete with each other for Chinese business, they diminish their leverage and thus reduce their chances of collectively striking a better deal with China.

This brief seeks to explore the implications of China's game-changing presence in Europe. It argues that Europeans should not blame China for taking the opportunity to expand its economic foothold inside Europe and leverage its financial and commercial influence with cash-strapped member states. But they should push for decisive steps to develop their own capacity to coordinate their interests in order to meet this challenge. In particular, they should leverage the EU's internal market to improve access in China, harness China's surplus financial resources for mutual benefit and improve Europe's level of unity instead of enlarging divisions. If they don't, they risk facing a version of the prisoner's dilemma, in which each member state will strike its own private deals and, in the process, undercut any possibility of a common policy towards China.

China's new European strategy

China no longer wants a "strategic partnership" with Europe. In 2008-2009, following recriminations on human rights, the continuation of the European arms embargo and the stand-off on Market Economy Status and a higher level of partnership, China downgraded its political expectations of Europe at the very moment when it upgraded its relationship with the United States, which it now saw as the most important partner. But the global economic crisis has also influenced China's strategy towards Europe again. China had always realised that its basic vulnerability in relation to Europe was its need for continued access to Europe's market. In fact, whereas the US depends on continued Chinese purchases of its public debt, the Europeans have needed almost nothing in return. But current account deficits and public debt emergencies have changed that. As one of China's top strategists put it bluntly: "You need our money." [1]

In fact, far from a new "strategic partnership", China is now in effect applying to Europe's periphery a set of strategies and tools that has paid off elsewhere in the developing world. China has long dealt bilaterally with countries in Africa, the Middle East and Latin America while paying lip service to regional institutions. It emphasises "mutual benefit", friendship and forms of assistance that go to the heart of local elites, builds up a chain of influence that extends from transport (ports, airports, roads) to local assembly (with designated Chinese industrial parks) and logistics (China's sea, air and container companies, telecoms networks) and eventually to distribution (from small-scale traders who form a sizable portion of Chinese immigrants to large distribution firms working up the value chain). Europe is now beginning to experience the same approach as China buys or builds infrastructure projects, snaps up ailing companies or collects assets from quasi-insolvent states, gets a foothold in the distribution sector and uses local media to increase its soft power.

Chinese soft power and public diplomacy in Europe

Alongside expanding its economic presence, China is also increasingly seeking to influence European elites. It now has more than 100 state-run Confucius Institutes promoting Chinese culture across the continent – in some cases subsidised by local partner universities. Its activities often support China's economic presence in Europe – for example, it is teaching Chinese to French workers at the Chinese telecoms company ZTE in Poitiers. The Beijing-based newspaper China Daily has launched a European edition and a supplement in the International Herald Tribune that comes with a warning that the newspaper cannot vouch for the content. Other well-established European media organisations such as Reuters now repackage content from Chinese state-owned broadcaster CCTV. Despite its official ideology of state sovereignty, China is also increasingly seeking to cultivate European politicians – for example, a newly established forum brings parliamentarians from across Europe to Beijing. At the same time, China seeks to limit the influence of Western culture: direct contact with Chinese civil society is severely curtailed, Western news sources and web sites are censored and the Chinese government releases only seven foreign movies a year.

China has particularly focused on the Mediterranean and south-eastern member states most in need of Chinese cash. This has created new relationships between peripheral member states and China. For example, Portugal, Italy, Greece and Spain now represent 30 percent of Chinese investments and trade facilitation in Europe, and Central and Eastern European countries another 10 percent – a disproportionately large amount given the overall size of their economies.[2] From a European perspective, it may seem as if the Chinese are exploiting Europe's soft underbelly. The danger for Europe is that there will be a kind of "China lobby" of smaller member states within the EU. Even after

1 Interview with authors, 26 May 2011.

2014 – when a majority decision at the European Council will require 15 member states with 65 percent of the population – China could depend on some of them – particularly Cyprus, Malta and Greece – to block any unanimous decision against its interests.

On the other hand, Chinese leaders say – with some justification – that they cannot win. “It seems that there will always be some one pointing fingers at us whether we buy it or not,” said deputy foreign minister Fu Ying in March.[3] They argue that improving relationships with individual member states, based on economic opportunities for China and its companies, will benefit EU-China relations as a whole. As a group of Chinese think-tankers have written, an improvement of China’s relations with individual member states will “give further impetus to the progressive development of China-EU relations”.[4] However, so far this does not seem to be happening, although China’s foreign policy chief Dai Bingguo meets regularly with High Representative Catherine Ashton. Reportedly, the EU-China summit in October 2010 almost ended prematurely when Prime Minister Wen Jiabao took offence at previously announced European demands on reciprocity and the renminbi’s exchange rate.

According to Zheng Bijian, the influential Chinese thinker who coined the phrase “peaceful rise”, Europe and China’s interlocking needs could create the possibility for a new relationship that would benefit both sides. “Europe’s top priority is now the employment issue, and it needs investment,” he says. “But Europe is still in the lead for high technologies, which creates opportunities for cooperation with China.”[5] While visiting France in February 2010, Foreign Minister Yang Jiechi outlined that this new economic interdependence at last gave a strategic content to the EU-China relationship. Viewed at this lofty level, there is indeed a historical opportunity to create a new deal between China and Europe based on mutual interest. But in order to take advantage of it, Europe will need to show greater unity of purpose in its approach to China.

There were signs that it was beginning to do so. After decades of steadily diminishing returns for Europe’s engagement and aid diplomacy, Europe’s key member states and much of the European Commission had begun to switch to an interest-based approach based on reciprocity and trade-offs with China. This involved an end to one-sided engagement and concessions to a supposedly weaker Chinese economy, and a will to balance Chinese access to Europe with European access to China’s much more closed economy. For example, European Council President Herman Van Rompuy and Trade Commissioner Karel de Gucht publicly supported reciprocity and Internal Market Commissioner Michel Barnier and Industry Commissioner Antonio Tajani signed a common letter on regulating investment from China.[6] At two meetings of the European Council in the second half of 2010, European leaders overcame internal divisions, at least on paper, around governance and human rights issues, alerted China to Europe’s concerns about proliferation and pushed for better access to China’s domestic economy as a trade-off for Market Economy Status – China’s main aspiration.

However, this agenda is now being threatened by new realities and priorities as member states agonise over austerity and the need for solidarity with the most indebted members of the eurozone. In particular, China is becoming more present in three ways: by purchasing (and creating the appearance that it is purchasing) European government bonds; by directly investing in companies, particularly in Europe’s periphery; and by participating in European public procurement.

China’s bond diplomacy

Since last summer, China’s purchase of southern EU member states’ public debt – or rather the prospect of it – has grabbed headlines. In June 2010, China bought Greek bonds as a quid pro quo for a 35-year lease on Piraeus harbour and a deal to finance the purchase of Chinese ships.[7] In July 2010, China announced that it would buy one billion euros of Spanish bonds.[8] The news turned around market confidence in Spain, and the bond issue was eventually oversubscribed – even though it is thought that China eventually bought only €400 million. China also made promises to Portugal and Ireland, though without reference to the timing or amounts, and again to Spain in January 2011. During Premier Wen’s visit to Germany, UK and Hungary in June, China again sent the message that a European recovery was “vitally important” for China.[9] Wen said China would buy “a certain amount” of Hungarian government bonds.[10]

We cannot be certain about the full extent of Chinese bond purchases. Although China publishes its total currency reserves, the composition of these reserves by country is a state secret. In fact, China’s own academics and state-run newspapers cite the foreign press when they provide figures for bond purchases.[11] Europe, for its part, publishes no aggregate or coordinated data on foreign purchasers of public

2 For the figures on the Mediterranean, see Grisons Peak China Outbound Investment research report, Quarterly Feature Volume 9, p. 4. For figures on Central and Eastern Europe (Poland, Czech Republic, Slovakia, Hungary, Romania, Bulgaria, Slovenia, Croatia, Serbia, Albania, Montenegro and Macedonia), see the figures provided by Chinese Vice Minister of Foreign Affairs Fu Ying in an interview with news agency Novinite, published on 21 March 2011, available at http://www.novinite.com/view_news.php?id=126501.

3 Ivan Dikov, “China’s Vice Foreign Minister Fu Ying: Chinese Companies Need Good Atmosphere to Do Business in Eastern Europe”, Novinite Insider, 21 March 2011, available at http://www.novinite.com/view_news.php?id=126501.

4 Chen Zhimin, Dai Bingran, Pan Zhongqi and Ding Chun, “China’s Priorities and Strategy in China-EU Relations”, University of San Pablo, Serie Unión Europea, Number 38, 2011, p. 17.

5 Zheng Bijian, “New thoughts on China’s peaceful rise”, Beijing Ribao, 16 May 2011.

6 Ian Wishart and Jennifer Rankin, “Call to investigate foreign investment in EU market”, European Voice, 24 February 2011, available at http://www.europeanvoice.com/article/imported/call-to-investigate-foreign-investment-in-eu-market/70364.aspx.

7 Center for International Finance & Development, “China Makes More Investments in Greece”, 7 November 2010, available at http://uicifd.blogspot.com/2010/11/china-makes-more-investments-in-greece.html.

8 “China buys $505m of Spanish bonds”, China Daily, 13 July 2010, available at http://www.chinadaily.com.cn/bizchina/2010-07/13/content_10101759.htm

9 Leigh Phillips, “EU recovery from debt crisis ‘vital’ to Chinese interests”, EU Observer, 17 June 2011, available at http://euobserver.com/9/32504.

10 Zoltan Simon and Edith Balazs, “Wen Says China Will Continue to Buy European Government Debt, Support Euro”, Bloomberg, 26 June 2011, available at http://www.bloomberg.com/news/2011-06-25/china-to-buy-hungarian-debt-as-wen-extends-support-to-european-finances.html.

debt in the 27 countries. Very few member states reveal any of this information. This double opacity means that figures for China's holdings in euros are no more than guesses. But in what amounts to a financial game of blind poker, it is in the interest of governments with pressing public refinancing needs to imply that "the Chinese are coming" in order to shore up their creditworthiness. For example, Hungarian Prime Minister Viktor Orbán told the press in June that China's commitment to buy "a certain amount" of its bonds provided "huge security" and removed "uncertainty about the country's medium-term financing".[12] Conversely, it is useful for China's public diplomacy to suggest it is a potential benefactor.

However, it now looks as if the extent of Chinese purchases of European government bonds in 2010 has been overestimated. In 2010, the US Treasury – which does publish exact figures for foreign bond holdings – seemed to suggest that there had been a modest decline of China's stock of US public debt, which in turn suggested that China was diversifying away from the dollar to the euro. But it now seems as if the Chinese continued to buy US Treasury bonds but did so through offshore or third markets such as the City of London. The US Treasury has now adjusted its figures for Chinese holdings of US treasury bonds to reflect this. For example, China's holdings in the month of June 2010 were revised up by 32 percent to around $268 billion. This in turn means that Chinese purchases of European government bonds are likely to have been much lower than press reports suggested. One European Central Bank (ECB) official now estimates that lending to crisis-hit southern European countries was in the order of 15 to €20 billion – "peanuts".[13] To put this figure in context, China lent $9 billion to DR Congo in 2008 in exchange for access to copper and cobalt mines.

Whatever the exact amount of its purchases of European government bonds, China has undoubtedly had an extraordinary run for its money in terms of media attention and public diplomacy. Its own opacity and use of third-party intermediaries on the financial markets is compounded by Europe's own ineptness at accounting for foreign purchases of European public debt. This is inherent to the limitations of monetary union: member states hold their own data on debt purchases and the ECB only gives figures for non-domestic buyers of sovereign debt, which includes intra-European purchases. In short, Europe is in an extraordinary position of ignorance about holdings of its own public debt. There is simply no way of knowing whether China holds 25 percent of its reserves in euros, as is often repeated in the media.

Europe should welcome China taking a larger stake in European public debt, as it has done in the US. The problem is that Europe has no real way of verifying whether such a large-scale Chinese diversification to the euro is actually taking place. All it can do is assume that, if China suddenly buys much less US debt than its rise in reserves would call for, it must be buying into European public debt.[14] The double opacity on bond purchases creates an unhealthy dependence for some member states on China, instead of a situation of interdependence between Europe as a whole and China. The consequence of not having a common or even coordinated public borrowing policy is that member states compete against one another in securing foreign creditors.

China's direct investment in Europe

The second way in which China is increasingly present in Europe is through direct investment in companies. Five years ago, the big story was about Europe's multinationals establishing production bases in China. At that time, China's total direct investment in Europe was $1.3 billion. So far in 2011, there have already been three acquisitions – of a Spanish oil company's Brazilian holdings, a Hungarian chemical company and a major Norwegian silicon unit – that have each exceeded that amount. Such deals suggest that the Chinese government has now given the green light to major takeovers in Europe. But although it is clear that the picture has changed in the last five years, we do not know exactly to what extent, because four-fifths of China's external capital flows take place via offshore centres such as Hong Kong and the Cayman and Virgin Islands. Whereas such centres used to serve mostly foreign firms investing in China or "round tripping" (i.e. Chinese investors using a foreign entity in their own country), they are now also being used by Chinese companies to buy European assets.

Greenfield projects, mergers and acquisitions, and trade and cooperation agreements relying on Chinese financing have suddenly raised the overall level of China's investments in Europe. For the last two quarters alone (i.e. from October 2010 to March 2011), Chinese firms and banks have committed $64 billion, or more than half of the total investment and trade facilitation flows in Europe since early 2008.[15] Admittedly, these figures include soft loans and deals that have been signed but not yet implemented, and therefore may be overestimated. Yet even the size of mergers and acquisitions suggests that, along with the US, Europe is suddenly overtaking Asia and the developing world – the first two targets of China's "going-out" strategy – as the top destinations for Chinese investment. There will inevitably be many more European acquisitions as China's overall direct investment grows from $311 billion at the end of 2010 to $1 trillion in 2020, according to a recent projection.[16]

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11 See, for example, Chen Zhimin, Dai Bingran, Pan Zhongqi and Ding Chun, "China's Priorities and Strategy in China-EU Relations", University of San Pablo, Serie Unión Europea, Number 38, 2011.

12 "Zoltan Simon and Edith Balazs, "Wen Says China Will Continue to Buy European Government Debt, Support Euro", Bloomberg, 26 June 2011.

13 Interview with authors, 16 June 2011.

14 Thus, a recent study by Standard Chartered Bank points to an unexplained gap of around $150 billion, a large part of which could have gone into euros. In particular, the study suggests China may have recently purchased €3.9 billion of European Financial Stability Facility bonds. See Lan Shen, Stephen Green and Thomas Costerg, "China: Less America, more Europe", Standard Chartered Global Research, 20 June 2011

15 Grisons Peak China Outbound Investment research report, Quarterly Feature Volume 9, Q1, 2011, pp. 1, 7 and 14.

Often, China invests in sectors in which it is at a comparative disadvantage and, in particular, where it wants to boost its own technological development in line with its next Five-Year Plan. Thus, China has created a €2.8 billion fund to help small- and medium-sized German firms invest with Chinese partners – with R&D and innovation explicitly cited as the key elements. In the automobile industry, investments range from takeovers of brands such as MG and Volvo, a strategic cooperation with Daimler (a crown jewel that is not yet for sale) and lower-tier production in Bulgaria where the Great Wall Motor Company is due to start production. Similarly, a small Chinese company with a market value of €400 million put in an ultimately unsuccessful €1 billion bid for Draka, a Dutch company holding important patents in fibre-optic cables. In other words, the battle over access to technology and intellectual property rights has now moved from China to Europe.

However, Chinese investment also serves other purposes and takes other forms. For example, the medieval city of Prato, near Florence, has become an offshore production base for 4,800 small Chinese companies with an estimated turnover of €2 billion and an estimated 40,000 Chinese workers. In Kalmar, in Sweden, China planned to build a 70,000 square metre wholesale trade centre designed to showcase Chinese goods and save wholesalers a trip to China. (The project floundered because its advocate in the local city government had acquired an economic stake with the Chinese partner and because Chinese labour was employed below Swedish standards.)[17] In Kista, also in Sweden, Chinese telecoms firm Huawei set up an R&D centre next to the head office of Ericsson, which was reducing its own labour force. Huawei's 280 employees there included 200 former Ericsson staff. [18]

Many of these diverse ventures are being supported by China's evolving financing arms such as the China Development Bank, which was originally a policy bank designed to aid China's interior provinces. After becoming a major force in African energy and infrastructure deals, it is now active throughout Europe, with offices and activities in several countries including Bulgaria, Croatia, Greece, Poland, Romania, Serbia and Slovenia.[19] Recently it financed the acquisition of an Italian fashion firm – a move that will help to give China's garment manufacturers some much-needed creativity.[20] In one such case, a group of Chinese companies announced a $10 billion loan from the China Development Bank and the China Merchant Bank to produce solar-panel manufacturers in Europe.[21] The deal is emblematic because only recently the EU was still granting aid to China's alternative-energy sector, particularly wind and solar power, in a well-meaning bid to encourage the reduction of emissions.

The corporate structure of Chinese companies presents a special problem. In particular, state-owned enterprises receive massive state subsidies and can therefore compete unfairly with European companies, even though the World Trade Organization (WTO) recently ruled that Chinese state firms and state finance banks are not "public bodies".[22] Chinese banks have received huge and permanent relief since 1998, far beyond recent American or European emergency measures. According to a recent and controversial Chinese study, China's state enterprises and holdings would have made losses since 2001 if direct and hidden subsidies (for example, the true costs for land use and the massive under-pricing of natural resources) were taken into account.[23] As a new response, Europe launched its first anti-subsidies case against China recently, targeting the Chinese subsidy model directly.

The problem is compounded by the lack of transparency of Chinese companies investing in Europe. China has maintained an opaque corporate structure on home ground, but when the companies move abroad, questions are asked. In particular, some so-called private companies are thought to be controlled by the state. For example, Huawei's stock is officially held by 150 employees but British newspapers have alleged that there is a shadow party structure inside the company.[24] Questions were also asked about who was behind the financing for the small Chinese company that was ready to bid for Draka, the Dutch fibre-optics company, at twice its market value and 20 percent higher than its nearest European competitor.

These developments have sparked a debate in Europe about the need for a process for vetting foreign investment. In the US, the Committee on Foreign Investments in the United States (CFIUS), an inter-agency body, vets foreign investment. As in the case of public debt purchases, Europe has neither data nor regulations. In principle, the Lisbon Treaty has given the EU competence in the investment field. In reality, however, only seven member states have any overall legislation concerning foreign investment. Thus, Huawei, which has alleged links to the People's Liberation Army and is prevented from acquiring telecoms networks in the US, has considerable leeway in most European countries. It tried to donate a mobile phone

16 Daniel H. Rosen and Thilo Hanemann, "An American Open Door?: Maximizing the Benefits of Chinese Foreign Direct Investment", Asia Society, May 2011, available at http://asiasociety.org/policy/center-us-china-relations/american-open-door.

17 Inno-Scandinavia, "Survey of Chinese investment flows to the Baltic region", 29 October 2009, pp. 23-24, available at http://www.wikivision.fi/basaar/pub/uploads/Project/Pdf/InvestmentFlows2.pdf.

18 Ibid, pp. 25-26.

19 Authors' interview with China Development Bank representative, May 2011. For deals and negotiations, see also Bulgarian Development Bank's website, available at http://bbr.nitbg.com/en/international-partners.html; "China Investment Bank interested in investing in Romania", Agerpres, 13 January 2011, available at http://www.doingbusiness.ro/en/business-news/20521/china-development-bank-interested-in-investing-in-romania; and Jade Ng, "China Development Bank sets sail for Greece", ALB Legal News, 21 September 2009, available at http://asia.legalbusinessonline.com/site-search/china-development-bank-sets-sail-for-greece/37190.

20 Zhang Yuzhe, "Mandarin Capital Teams Up With Miroglio", Caixin Online, 6 July 2010, available at http://english.caing.com/2011-06-07/100266975.html.

21 "CTDC to Expand and Invest in Europe - PV Investment Consortium Seeks Partnership with European Solar Park Developers", China Technology Development Group Corporation press release, 13 June 2011, available at http://www.chinactdc.com/templet/en_news.asp?id=897.

22 World Trade Organization, dispute settlement DS379: United States – Definitive Anti-Dumping and Countervailing Duties on Certain Products from China, 25 March 2011, available at http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds379_e.htm.

23 Unirule Institute, "Guoyou qiye de xingzhi, biaoxian yu gaige (The nature, performance and reform of the state enterprises)", 4 April 2011, pp. 2 and 6.

24 Tim Watkins, "There's no Chinese 'shadow party structure' inside our company", The Guardian, 27 May 2011, available at http://www.guardian.co.uk/commentisfree/2011/may/27/independent-chinese-profit-based-company.

network for the London Underground ahead of the 2012 Olympics – a project finally abandoned by its British partners because of a "lack of time". In Italy, it is building a nationwide network with Telecom Italia.

The problem presented by Chinese direct investment in Europe becomes even clearer when one considers Europe's limited access to similar opportunities in China. China's capital market remains largely closed in sectors that the government deems important for its economic development strategy: this exclusion of "strategic sectors" is permissible under the terms of China's WTO accession in 2001 – when China's global exports were only one-sixth of their 2010 level. In many sectors, ranging from air transport to banks and alternative energy, foreign stakes are limited to 20 percent of capital. The barriers to foreign capital have in fact increased with the passing of legislation favouring "domestic innovation". Europeans and Americans have succeeded in getting official statements from the Chinese government to refrain from extending this policy but, according to many observers, this has made little difference on the ground. In a nutshell, this means that China's Geely can buy Sweden's Volvo but Chinese regulations can block the reverse.

Europe's open market for public procurement

The third way in which China is becoming present is Europe is through Europe's open market for public procurement. Spurred on by China's "going-out" strategy, its companies have in the last decade been successfully building infrastructure around the world – everything from railways in Saudi Arabia to ports in Africa. Now, however, they are taking on Europe. The focus is cash-strapped countries in Europe's periphery where there is a need to upgrade roads, railroads and public buildings. But the same thing could easily be soon happening in Europe's core. After all, a Chinese company is also building San Francisco's new Bay Bridge in Shanghai.

At a time of austerity, European states are understandably attracted by the same economies of scale which have made Chinese consumer goods cheap. Talks with European diplomats reveal that China's high-level trade delegations are asking for shopping lists of infrastructure projects on which their companies can bid. An Eastern European country is actively seeking Chinese bids to build water-purification plants to comply with European regulations on water. Serbia acquired a bridge over the Danube with financing from the China Development Bank. That particular deal had a timely coincidence with the push by China for empty chairs at the unrecognised Chinese Nobel Prize winner Liu Xiaobo's award ceremony in Oslo. Serbia initially inclined to go with Beijing's demand but in the end – and after EU pressure – followed its European vocation and showed up in Oslo.

Another interesting example is the Polish government's contract with a Chinese state-owned enterprise to build the A2 highway between Warsaw and Lodz with European funding. After signing the contract, COVEC, whose bid came in at less than 50 percent of the 2.8 billion zlotys ($1 billion) that the government had budgeted, proceeded to bring Chinese workers into a country that exports its own labour force to Western Europe. COVEC pulled out of the contract in June 2011, leaving a half-finished highway that is now less likely to be completed in time for the European Football Championship in 2012, as originally hoped. The official reason was that prices of construction materials had gone up; the unofficial reason was European legislation on a range of issues from labour to immigration standards.

Although it ultimately fell through, the Polish highway deal is an illustration of what the future may look like: Chinese companies offering low prices – based on the use of Chinese employees working below European labour and environmental standards – and attractive terms that would be unattainable by European companies with local wage and financial conditions. In order to avoid attracting attention, Chinese companies often try to make bids through local companies, as is the case in Bulgaria. "When there is EU funding, the Chinese are very interested, but they don't want to be at the frontline", says a European official.[25] "That is part of our price," says a Chinese official in response. "We can do a project in one year on our terms. Otherwise, it takes the locals 10 years."[26]

Meanwhile, as with direct investment, European companies are excluded from the equivalent market in China – which is the size of the whole economy of South Korea, itself a G-20 country.[27] In a recent report on public procurement, the EU's Chamber of Commerce in China described in painful detail the twisted logic with which the Chinese state rejects bids from foreign countries even when it allows them to apply. European companies have a lead in many sectors from urbanisation and public transport to alternative energy and the management of social systems. Combining a "hard" technological edge with "soft" management and project integration skills, they are uniquely suited to the needs of tomorrow's China. However, they rarely win contracts because China has not yet joined the WTO's Agreement on General Procurement (GPA), which regulates public procurement. China's last offer, in 2010, only included one-tenth of its real public-procurement market, since it didn't include the purchases and infrastructure investment by state-owned companies and local entities. This means, as one European trade official in Beijing put it, that "it includes pencils and rulers" (and cars, which European automakers are happy to provide) but not much else. Bidding for virtually all of China's internationally known mega-projects such as the Three Gorges Dam, Olympic stadiums and bullet trains is administered instead by the National Development and Research Commission (NDRC).

25 Interview with authors, March 2011.
26 Interview with authors, May 2011.
27 European Chamber of Commerce, "Public Procurement in China: European Business Experiences Competing for Public Contracts in China", April 2011, available at http://www.europeanchamber.com.cn/images/documents/marketing_department/beijing/publications/2011/PP%20Study%20EN%20Final_0421.pdf.

Public procurement is a test case for Europe's strategy of reciprocal engagement. The EU is currently preparing to launch a new legal instrument on bidding for European public procurement. There is still considerable debate as to whether this should be a mandatory regulation that would be enforced by the European Commission or merely guidelines that would be implemented and supervised by member states. It is also not clear whether the regulation would make it possible to cut off companies from countries whose own markets remain closed. The instrument would not be limited to China and could also apply to other partners such as the US, which has a Buy American Act, and Japan, which also makes life hard for foreign bidders.

China has noted these rumblings in Europe. In fact, the NDRC, which runs the planned domestic sector and usually does not stray from China, was concerned enough to send officials to Brussels to investigate how far Europe could be taking this. But, until now, China has shown few signs that it is prepared to change its policy. For example, two successive drawn-out rounds of negotiations on the terms of a GPA have not produced results. In any case, public procurement is an ideal playground for obfuscation, fuzzy rules and barriers to trade. A soon to be published study based on a sample of 112 countries shows that "international procurement agreements have no effect on governments' purchasing behaviour: Signatories are no more inclined than non-signatories to spend public funds on imports."[28] Only very tight reciprocal preferential agreements and a genuine commitment to mutual openness can ensure implementation.

Europe's new fault lines

China's growing presence in Europe is transforming the nature of the European debate about China. In 2009, ECFR's Power Audit of EU-China Relations revealed four distinct European groups of countries in their attitudes towards China (see Figure 1).[29] At that time, the European debate was polarised by the issues of anti-dumping and China's demand for Market Economy Status. However, the increasing dependence of the periphery on China is changing this typology and its reference points:

- the "European followers" – which previously paid little attention to China – are now on the verge of extinction. Gone is the time when European policy towards China was made by a handful of key member states while others were happy to follow their lead. China is now part of virtually every country's calculations in trying to overcome the economic crisis.

- the "accommodating mercantilists" – which were politically non-confrontational but had protectionist instincts – are increasingly desperate for Chinese investment. For southern European countries such as Greece, Italy, Spain and Portugal, which were at the forefront of Europe's textile disputes with China, the need for cash now takes precedence over their concern for their labour-intensive industries (for example, emblematic anti-dumping measures on shoe imports from China expired in March 2011 without a whimper from the Mediterranean rim). Meanwhile, Central and Eastern European member states such as Bulgaria and Hungary, which were already vying for Chinese investment, are now seeing European flows of investment drying up and are thus increasingly dependent on China.

- the "ideological free traders" such as Denmark, the Netherlands, Sweden and the United Kingdom – which were interested in opportunities on the Chinese market for their high-tech and service firms – have been frustrated by the continued restrictions to access to China's market. They are aware that a strong bargaining position is needed to open China's market and to push for more equal rules with the world's fastest growing economy. Yet they too need business deals in the short term and are therefore under pressure to delegate to the EU the difficult task of claiming reciprocal access while seeking contracts for themselves.

- the "assertive industrialists" – who stood up to China on both economic and political issues – have split. Germany – Europe's export-driven Middle Republic, which has benefited greatly from demand from China for its exports in recent years – increasingly sees Chinese companies moving up the value chain and competing with its own exporters both in China and elsewhere around the world. Meanwhile, the Czech Republic and Poland have become less assertive on economic issues in order to attract Chinese investment.

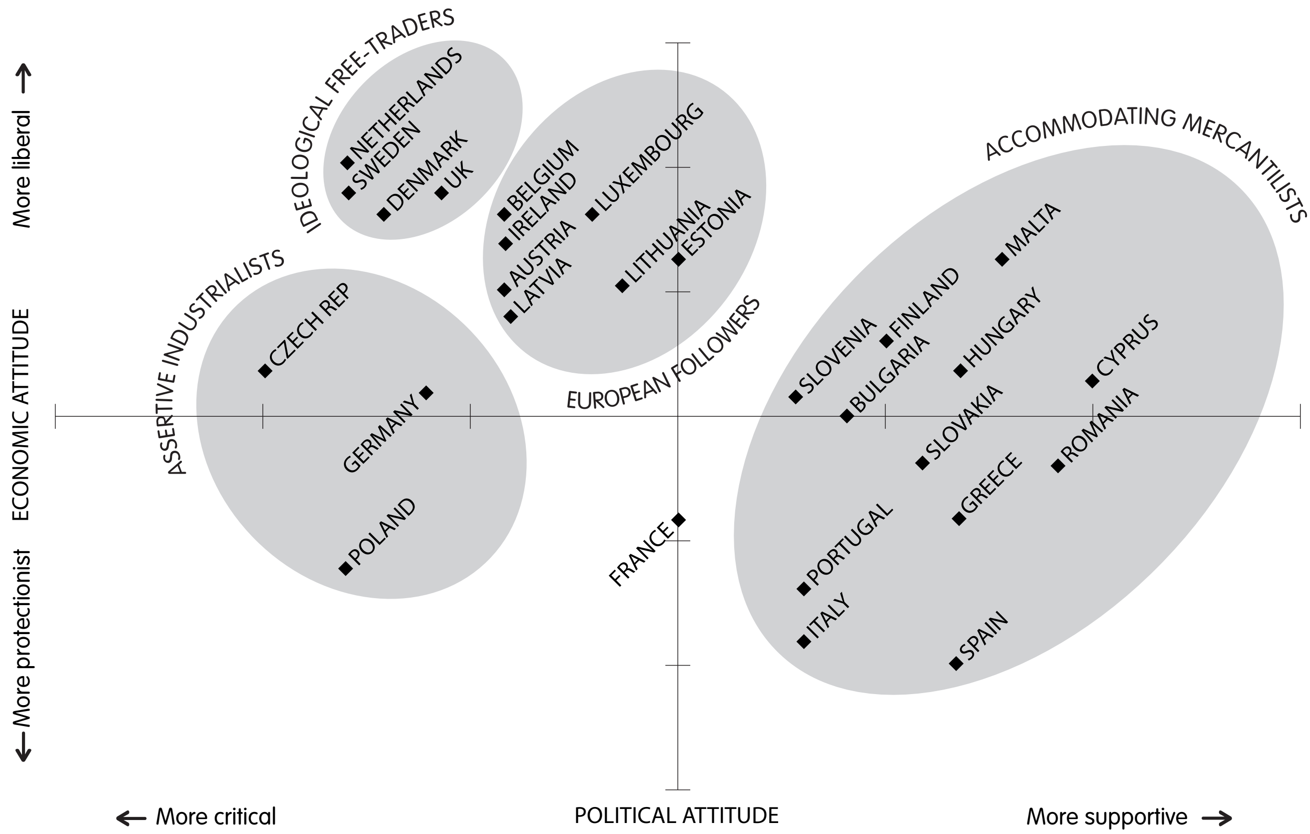
As a result of these shifts, new fault lines have emerged within Europe. In particular, Europe is increasingly divided into "frustrated market-openers" and "cash-strapped deal-seekers" (see Figure 2). Despite growing frustrations, the former "ideological free traders" still oppose moves to restrict China's own access to the European market – both on principle and because they believe it is ultimately in their own interests. However, they increasingly see the value of using the threat of such measures and of ways of enforcing free trade as a negotiating tool with China. Meanwhile, despite Germany's salesman instincts – for example, one top-level official in Berlin has described his role as "ambassador for Daimler" – it is increasingly arguing for reciprocity, particularly on public procurement. For example, Economics Minister Philipp Rösler said in June that "free markets cannot be a one-way street".[30]

28 Stephanie J. Rickard and Daniel Y. Kono, "Policy Transparency and Compliance with International Agreements", Working paper, January 2010, available at http://147.142.190.246/joomla/peio/files2011/papers/Kono,%20Rickard%20 14.01.2011.pdf. The authors are grateful to Soo Yeon Kim of the Transatlantic Academy for pointing out this issue to them.

29 John Fox and François Godement, "A Power Audit of EU-China Relations", European Council on Foreign Relations, April 2009, available at http://ecfr.eu/page/-/documents/A_Power_Audit_of_EU_China_Relations.pdf.

30 "Rösler sieht China als Chance", Focus Online, 27 June 2011, available at http://www.focus.de/politik/deutschland/deutsch-chinesische-regierungskonsultationen-roesler-sieht-china-als-chance_aid_640453.html.

Figure 1: Member state attitudes to China before the crisis

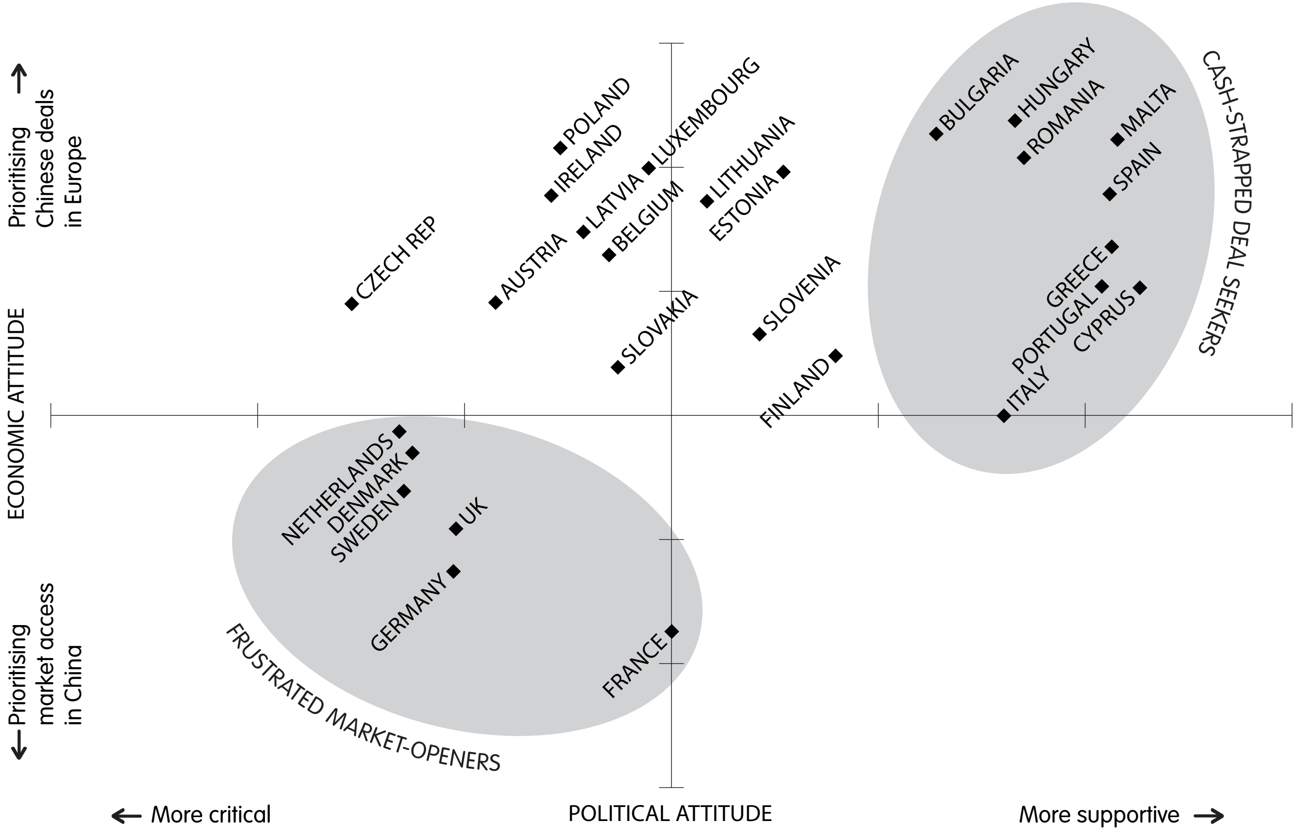


In that sense, both the former "ideological free traders" and Germany seem to be quietly moving towards the position of France – which has always been the leading advocate of a strong common European bargaining position with China in order to protect its companies (luxury handbag manufacturers, prestige wine producers, and aerospace and train companies) from unfair practices by Chinese competitors. "It's a real war, with highly subsidised companies coming to open markets with unusually low prices and undercutting the competition," a French official recently said. "It's not capitalism, it's not trade, it's predatory policy."[31]

However, although France, Germany and the UK are moving closer together as "frustrated market-openers", this unity is being undermined by the "cash-strapped deal-seekers". In particular, member states on Europe's periphery that had long considered China's market with caution and feared dumping by China's low-cost producers now see China as a complement or even an alternative to European or IMF loans. Some even prefer it: in the words of a high-ranking Portuguese official: "Better the bonds are bought far away."[32] These countries, which never had much hope of exporting to China in the first place, are now even less likely to back a reciprocal approach to China than they used to be. "Our companies can't compete in China, so it doesn't matter to us if China opens up its public procurement market", says one Eastern European official.[33] "What have Germany and Europe done for us lately?" asks an official in the foreign ministry of a Mediterranean member state. "How can they have the nerve to ask us to coordinate and unite our European interests on China when there is no common economic interest?"[34]

31 Discussion with authors, Paris, May 2011.
32 Interview with authors, March 2011.
33 Interview with authors, Beijing, March 2011.
34 Interview with authors, November 2010.
35 Viktor Orbán, Speech at the China – Central and Eastern European Countries Economic and Trade Forum, Budapest, 27 June 2011, available at http://orbanviktor.hu/in_english_article/speech_by_viktor_orban_at_the_china_central_and_eastern_european_countries_economic_and_trade_forum.

Figure 2: Member state attitudes to China after the crisis



Note: the above charts are based on member states' policies on political and economic issues. In both charts, the political issues in were the prominence of human rights issues, willingness to raise global issues with China (Iran, Sudan etc.), Taiwan, Tibet and willingness to meet the Dalai Lama as well as general political statements on China. In Figure 1, which first appeared in ECFR'S Power Audit of EU-China Relations, the economic issues were policies on anti-dumping and trade deficits. In Figure 2, the economic issues were policies towards Chinese investments and government bond purchases, interest in obtaining increased access to Chinese markets and the establishment of a possible EU instrument on public procurement.

These new divisions are weakening Europe's approach to China. For example, when Premier Wen Jiabao visited Budapest in June and announced a new €1 billion credit line for Hungarian companies, Hungary's Prime Minister Viktor Orbán – who happened to be acting president of the EU – talked of a "new alliance of major significance with the People's Republic of China".[35] There was no mention of human rights during the trip and the government tried to silence Tibetan pressure groups. This silence illustrated the shift in Hungary's stance on human rights in China: Orbán met the Dalai Lama when he was prime minister in 2000 but did not do so when the Tibetan leader visited Hungary again in 2010.[36] Fittingly, it was during another visit to Budapest that Chinese deputy foreign minister Fu Ying reminded Europeans that "positive signals should be followed by a positive response".[37]

Thus, although a larger number of countries now have a stake in relations with Beijing and therefore want to take part in discussions on China, this is not leading to a more coordinated and forward-looking European policy. On the contrary, China's meticulous bilateral approach to each member state, the pull of short-term national interests, and perhaps even the need for elected politicians to demonstrate to their voters that they are fighting the gloomy economic context, is leading to a fragmentation of EU-China policy. As one prominent Chinese academic observes: "There is a race to the bottom: everyone is offering us incentives for investment from China."[38]

36 See "European Foreign Policy Scorecard 2010", European Council on Foreign Relations, March 2011, available at http://www.ecfr.eu/content/entry/the_european_foreign_policy_scorecard.

37 Eva S. Balogh, "Viktor Orbán in the limelight: Wen Jiabao in Budapest", Hungarian Spectrum, 25 June 2011, available at http://esbalogh.typepad.com/hungarianspectrum/2011/06/viktor-orbán-in-the-limelight-wen-jiabao-in-budapest.html.

38 Interview with authors, April 2011.

A level playing field

Any attempt to improve European companies' access to Chinese markets must therefore begin with the re-establishment of Europe's bargaining power as a united group. Europeans are not likely to disintegrate and renounce their unified approach to WTO rounds. But their unity in negotiations is threatened by the new divisions that have emerged as a result of China's presence in Europe. There is no question therefore that China's state-led economy will continue to keep Europeans divided if they are already fragmented by their political and economic interests. That does not mean Europe should blame China for what it is – a hard-working but state-driven economy that has harnessed labour and savings to become a global economic force. But Europeans do need to unify around their collective interests. Europe does not have the option of closing or managing trade because this would raise the price of its imported goods and services and thus hurt its standard of living. Rather, it should aim above all for a level playing field or mutual access to the Chinese economy. This means a carefully considered and consistently implemented strategy of reciprocity that will involve partners who can be its competitors. Europeans will also need to consider their own failings. For example, it is right to criticise Chinese subsidies of their overseas contracts. But China's mercantilist logic could be taken from the handbook of some European industrial policies. Because protected sectors still abound in its own economy, Europe needs competition. If the cost of Europe's transport, telecoms and energy infrastructures was to go down as a result of Chinese competition, this would be welcome news to European consumers. However, it must be fair competition.

In particular, Europe faces two challenges. It must retain and enlarge the regulatory and bargaining capacity on which the single market was founded. But it must also seek a balanced model for economic exchange with China, which will in fact help to reform both economies. In other words, it should accept growing interdependence but make sure that both sides are dependent on each other rather than simply increasing European dependence on China. There are only two other options: protectionism, which would only make Europe less competitive globally and raise its costs; or a free-for-all acceptance of subsidised Chinese capital and low-cost providers of investment and public goods, which would weaken the bargaining position of every EU member state and create an insecure environment for Chinese firms, as well as political and social tensions in Europe.

The Chinese presence in Europe thus calls for the same response as for the sovereign and banking crises: a demonstration of political unity and a policy process that matches this unity. This will not be easy at a time when the priority of many European governments is to achieve budgetary cohesion or survive the next election. As the ambassador to China of one member state in urgent need of investment sighed: "We hope that Europe won't strike back before we get our deals done."[39] Nevertheless, there are measures that Europe can take to respond to each of the three ways in which China is increasingly present in Europe. They will prevent China from using its financial power to gain undue political leverage in Europe and ultimately create a rules-based and level playing field on which European firms are able to compete in China in the same way that Chinese companies can in Europe.

A coordinated system for government debt purchases

Following the example of US Treasury statistics, the EU should have either a unified statistical system to account for foreign holders of public debt or a coordinated system to ensure that member states use similar accounting standards. This would not so much change conditions on the buy side for China or other investors as create clarity in the eventuality of a sell-off. At present, Europe's lack of accounting and China's own opacity mean it can buy with a fanfare, maximising the result for public diplomacy, and sell without any publicity, thus holding a threat over countries with which it has a disagreement. This situation threatens European unity in both foreign policy and trade and investment policies. China would also benefit from the revelation of its holdings in the debt of core member states or European bond issues as they materialise.

A system for vetting direct investment

Given the huge degree of regulatory and administrative oversight in China, it is only fair that Europe should expand the mandate of its internal market and trade divisions to supervision of investment. In specific areas such as defence, critical technologies, media and education, a supervisory body should closely scrutinise the buying party and consider the implications for European security and liberties. There should be a wider form of enquiry, perhaps involving the European Parliament at some stage, for investments of any kind that exceed $1 billion – a ceiling still substantially higher than China's control by central authorities. If Chinese firms find it hard to convince Europeans, they may offer better terms or press their own government to go for reciprocity: as large and as fast-growing as it is, China's market is smaller than Europe's. More broadly, Europe should aim to negotiate a multilateral investment treaty, thus leveraging other international partners to put China on notice. This would also mean more information on ownership of Chinese companies and their overseas subsidiaries.

39 Interview with the authors, Beijing, March 2011.

40 European Commission, "Trade, Growth and World Affairs: Trade Policy as a Core Component of the EU's 2020 Strategy", November 2010, available at http://trade.ec.europa.eu/doclib/docs/2010/november/tradoc_146955.pdf

Fair competition in public procurement

Chinese companies bidding for contracts in Europe often benefit from soft loans and other cost factors which are borne by public banks and other providers to these firms. It is unrealistic to think that the EU could block member states from accepting such bids, but it could deny EU subsidies to public projects involving companies from countries that do not grant access to their own public markets. This would not be a protectionist measure – for example, it would not go as far as the Buy American Act. The EU is currently considering a new legal instrument that would seek to achieve symmetry with Europe's partners in this way.[40] A second possibility would be to create a quantitative index of the foreign share of public markets in both developed and emerging economies. This measure would help to open up other closed markets such as Japan's and would also benefit third-party providers in Europe as well as in China. A first step would be to incorporate such a measurement into the upcoming negotiations on a Europe-Japan free-trade agreement. Japan, with its closed public procurement, has often been a role model for China's foreign-trade negotiators, so such a provision could have a knock-on effect. These steps could also encourage China to make an offer to open its public procurement that goes beyond what is covered by the WTO's GPA.

At a time of austerity, China's focus on bilateral relations with member states, its rather obvious political conditionality with weaker economies, and the opacity of its monetary and financial transactions are adding to the centrifugal forces already at play in European politics. China needs Europe and the European market for business – but it may also want a divided Europe for its own purposes. There is nothing to prevent cash-strapped European economies from going for immediate bargains with China. But if they trade support for China's policies across the board for short-term financial aid, Europe will be weakened from the inside. On a range of issues from global financial reform and international governance to environmental norms and human rights, it will pay the price.

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