



April 2016

## Future EU-China Trade Relations: Towards a modern Silk Road

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### EXECUTIVE SUMMARY

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<b>STATE-OF-PLAY</b>	2016 is a challenging year for trade relations between the EU and China who are <b>economically interdependent in many ways</b> . This year, the policy space has been captured by an issue that has the potential to sour relations, which is the granting of Market Economy Status to China by members of the World Trade Organisation.
<b>AMBITIOUS AIMS</b>	In order to keep pace with the <b>increasing importance of bilateral commerce and the vast potential gains from open trade</b> , both entities have to navigate the sensitive issues while at the same time work towards the further opening of markets and removing trade barriers. The European retail sector puts high expectations on the ongoing negotiations for an <b>investment agreement</b> which, in the long-term, should pave the way for an ambitious <b>free trade agreement</b> .
<b>IMPORTS TO EUROPE</b>	Trade is double-sided like a coin; it consists of imports and exports. Despite the <b>high relevance of Chinese imports for the European Single Market</b> , China is unfairly perceived as a menace to the economic prosperity of the EU.
<b>MARKET ACCESS IN CHINA</b>	The barriers that European companies still face when running business activities in China jeopardise the progress in establishing closer trade relations: <ul style="list-style-type: none"><li>• European retailers are <b>missing a level-playing field</b> in China owing to many persistent technical barriers, unnecessary bureaucratic hurdles, and discrimination of foreign-invested enterprises.</li><li>• The poor enforcement of <b>intellectual property rights</b> causes severe economic damage to FTA members.</li></ul>
<b>WAY FORWARD</b>	For the sake of mutual growth both sides have to <b>cooperate more effectively</b> and refrain from protectionist measures. Removing the many existing trade barriers and promoting deeper economic cooperation remains of paramount importance in the bilateral relations. The recent comprehensive study on EU-China economic relations commissioned by the FTA from the Centre for European Policy Studies, goes a long way to showing the benefits of closer ties.
<b>ANNEX</b>	A <b>list of existing trade barriers</b> to which European retailers are still exposed in China can be found in the Annex.

## 1. INTRODUCTION – TWO INTERDEPENDENT TRADE PARTNERS

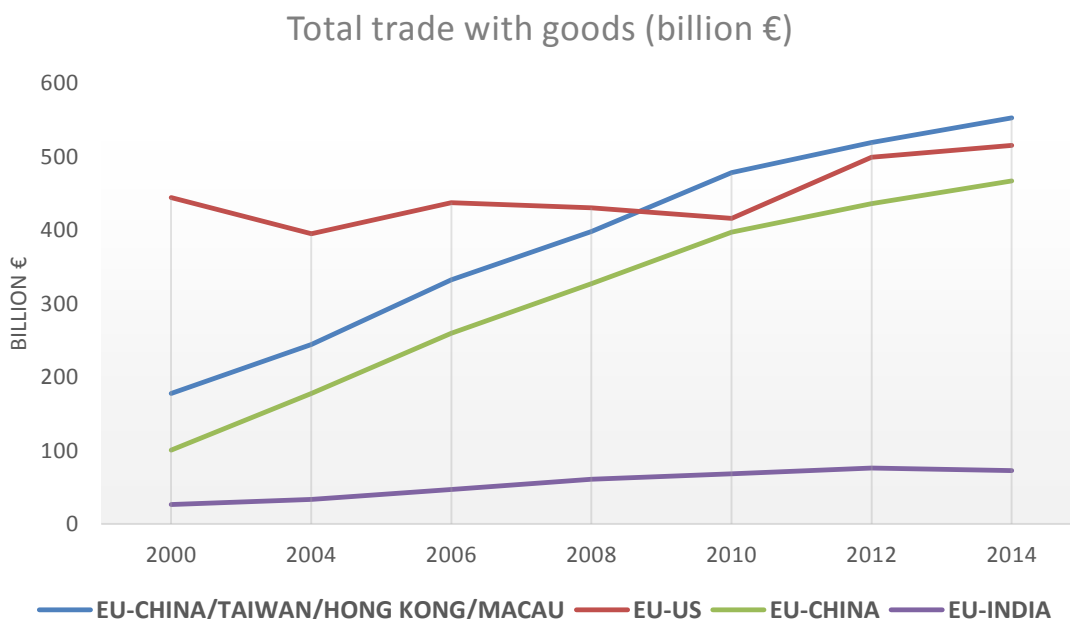
The European Union and China established economic relations in 1975, and during the past four decades, bilateral relations have undergone a significant change and have developed into a **real success story**. In 2014, the EU was China's largest trading partner (13.4% of total share) and China was the EU's second largest – and might soon replace the USA in the first place.

Not surprisingly, the **Foreign Trade Association (FTA) attaches utmost importance to trade relations with China**. China is by far the most important supplier for European importers and retailers, and therefore its importance as sourcing country is immense, even though imports recently have a declining tendency. According to FTA statistics, China's share in the total volume of imported non-food products in 2014 was 54%. At the same time, China is gaining importance as an export and investment destination for FTA members. European retailers are progressively penetrating the Chinese market, due to rising incomes and population density.

In order to keep pace with the increasing importance of bilateral commerce and an increasingly globalised world, both entities have to create an even more business friendly environment by further opening markets and abolishing trade barriers. **Not all potential has been utilised yet**. Therefore, FTA highly welcomes two recent initiatives which will improve trade relations between the EU and China:

- 1) Opening of **negotiations on a bilateral investment agreement** which will lead to liberalisation of investments and elimination of restrictions for investors in both markets. FTA campaigned for the launch of negotiations and will accompany the talks until conclusion.
- 2) President Xi Jinping suggested that the EU and China could **work together on negotiations for a wide-reaching free trade agreement**. The ambitious idea for such an agreement was already formally included in the summary of the bilateral summit in 2014 and is no longer merely a consideration.

*The increasing relevance of EU-China trade in comparison with other economic powers:*



*(Source: European Commission 2015)*

## 2. OBSTACLES AND SHORTCOMINGS – MORE EFFORTS NEEDED

### a) Acknowledge the importance of Chinese imports for the Single Market

Many European companies have production facilities in China or source from local manufacturers in order to benefit from competitive cost structures and the country's ability to produce quickly, economically and in high volumes. As a consequence, European consumers now have **access to a larger variety of products** than ever before and can benefit from affordable and high quality merchandise. In other words, the **purchase of imports from China** has become an **integral part of our consumer behaviour**.

Despite these developments, many European policy makers and the public perception tend to underestimate or even overlook the added-value of a liberal trade regime with China. It is therefore one of the main objectives of the FTA to raise awareness of the **crucial role of Chinese imports for the internal market**. The EU institutions should recognise more actively the benefits of the current trade exchange and **pursue a policy of openness in bilateral commerce**.

The Single Market must remain open and **protectionist temptations must be resisted**, especially against the background of the continuing economic recovery in the EU after the financial crisis. The use of **trade defence instruments** is legitimate to defend European producers against unfairly subsidised or traded imports. However, the use of such instruments has to be clearly framed and should not be dictated by narrow and short term goals or by calls to protect uncompetitive European industries. Hence, calls to have an increased recourse to such measures should be rejected.

An excessive and unjustified application of trade defence instruments will only provoke countermeasures by China and diminish the prospects of growth in bilateral trade. This is all the more important since trade statistics indicate that **European exports to China are expanding at a higher pace** than imports from China to the EU. In the years between 2010 and 2014, **exports from the EU to China grew by 45.2%**, during the same period imports from China to the EU increased only by 6.6%. This trend demonstrates that the EU is already on the right track and that China is more open and an increasing demand exists for European exports.

### b) Facilitate retail and supply chain activities in China

The retail market in China is undergoing a profound transition. In 2014, retail sales in China amounted to around €2,800 billion and the **Chinese retail market is expected to be the world's largest by 2018**. Already today, the country is the largest e-commerce market in the world. Despite these considerable growth prospects, **business activities of European retailers and brand companies operating on the Chinese market continue to be affected** by risks of technical barriers, violations of intellectual property rights, and mistrust in foreign and local non-governmental organisations (NGO).

#### *Reach a level playing field for European retailers*

Although ownership restrictions and geographic limitations for foreign investment have been removed in 2004 in nearly all retail sectors, major market access obstacles remain:

- 1) **CUSTOMS**: European retailers have experienced various difficulties with Chinese customs. Practices may be substantially different from one part of the country to another as procedures are not properly harmonised. The **lack of clear implementation guidelines** is leaving broad discretionary power to local seaport and airport authorities. Moreover, import procedures often do not allow for very large consignments which have to be divided into smaller batches.

- 2) **PRODUCT SAFETY:** The trading sector is strongly and naturally committed to bringing only safe products onto the market. Therefore, European retailers welcome the robust testing and enforcement policy in place in China. Legislation on consumer protection, however, needs to be balanced and manageable, and should not **lead to a disproportionate level of trade distortion**. The current testing scheme discourages exporting to China because of the complexity of the system, the intensive costs for quality and safety testing, and the exaggerated delay before the approval of shipments.
- 3) **PROTECTIONISM:** The “**Buy Chinese**” policy, limiting the access of foreign companies to public procurement, contradicts the Chinese government’s stance to treat foreign goods fairly with regards to stimulus spending and their calls to other governments to stick to the principle of free trade. The “Buy Chinese” policy is governed by the Government Procurement Law and entered into effect in 2003.
- 4) **LICENSING PROCEDURE:** Experience has shown that **foreign retail companies face stricter licensing processes than domestic players**, adding costs and delays for foreign investors. Provincial commerce authorities, being in charge of granting business permits, tend to favour domestic over foreign retailers and either restrict the number of licences available, or deny certain licences to foreign companies. In short, the licensing procedure lacks transparency and often remains inconsistent, slow and cost intensive.
- 5) **REAL ESTATE:** In many cities **local authorities are inclined to grant prime real estate spaces to domestic retailers**, clearly disadvantaging foreign players. Furthermore, with the recent soar in estate prices, loopholes in the lease contracts are included to force foreign renting parties out of their contract if better offers by local retailers are available.

#### *Achieve a high level of Intellectual Property Rights (IPR)*

FTA recognises the efforts to align China’s laws and procedures to international standards and for raising awareness on the consequences of piracy. Nevertheless, **the scale of the problem is still very significant and IPR infringement has a serious impact on European companies**. European single-brand companies and retailers with own-brands are strongly affected and become frequent and common targets of counterfeiting. Heavy economic losses are the direct consequence. Moreover, counterfeiting is a crime and European retailers are exposed to legal actions for selling counterfeited goods involuntarily to their customers. Hence, further support should be provided in order to assist China in enforcing relevant laws and regulations.

Despite continuous improvement, around **80% of counterfeit products** (with a value of €341 million) that were detected at EU-borders in 2014 originated from China. China remains by far the **leading country of provenance** from where goods suspected of infringing IPR were sent to the EU. To understand the magnitude of this, Hong Kong ranked second in entities of provenance with IPR infringements and sent “only” a total of €84 million worth of goods to the EU in 2014.

### **3. THE BILATERAL INVESTMENT AGREEMENT: STEPPING STONE TO A FREE TRADE AGREEMENT?**

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With the negotiations for a bilateral investment treaty between the EU and China which started in late 2013, a **new dimension of a strategic relationship is reachable**. The EU seeks to replace the existing 27 individual member states’ treaties with one single EU-China investment agreement.

- 1) So far nine rounds of negotiations took place, **but at the moment progress is slow** and more efforts are needed to accelerate the talks. The conclusion of an investment agreement can have far-

reaching consequences, because it is expected that this will be the **first step to a larger free trade agreement**.

- 2) The agreement should **incorporate a strong implementation chapter** to ensure that economic operator can derive maximum benefit from the provisions. A **dispute settlement mechanism is indispensable** and should allow companies to challenge governmental decisions with regard to **unfounded investment and market access obstacles**.
- 3) An investment agreement should also aim at improving bilateral **cooperation and dialogue on sustainability issues** without allowing one side to impose its model and views. Representatives from both entities, including from the civil society, should have periodic meetings to evaluate the implementation of the sustainability provisions.

#### 4. A BILATERAL TRADE AGREEMENT: A MODERN SILK ROAD?

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Trade relations between the Europe and China date back to the ancient Silk Road, and today **they constitute one of the most important economic partnerships in the world**. Nevertheless, there is still a vast amount of space for further growth and development in these relations.

According to the recently published independent study by the Centre for European Policy Studies (CEPS)<sup>1</sup> and the World Trade Institute, which was commissioned by FTA, **the potential benefits of closer and open economic trade relations between the EU and China are significant**. Both the EU and China would profit from such an agreement, and so would all EU Member States.

The state-of-the-art economic modelling on which the study is based, suggests that an ambitious free trade agreement between the EU and China could have an estimated **GDP impact of 1.87% on China and 0.76% on the EU by 2030**. In today's terms, this means an additional €89 billion for China and €83 billion for the EU, which in total would be like adding the GDP of a country like the Czech Republic to the economies of China and the EU.

These projections clearly indicate that **the potential for jobs and growth is significant**, and adds weight to FTA's calls for the EU and China to embark on negotiating such an agreement as soon as possible.

#### 5. CHINA MARKET ECONOMY STATUS: TO ME OR NOT TO ME?

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All recent discussions on EU-China economic relations have been overshadowed by the question of whether the EU is obliged to grant China Market Economy Status (MES) under Section 15 of China's Protocol of Accession to the WTO.

From a purely legal standpoint, **FTA believes that there seems to be no clear answer regarding China's status after 11 December 2016**. On the one hand it would appear that the status quo remains – on the other, that WTO members will no longer be permitted to treat China as a non-market economy.

FTA is aware that it is likely that if Chinese companies are treated *per se* as operating under market economy conditions, the normal value and therefore the dumping margin (and subsequently dumping

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<sup>1</sup> J. Pelkmans et al. "Tomorrow's Silk Road: Assessing an EU-China Free Trade Agreement", April 2016, CEPS, Brussels

duty) could decrease. However, the basic Regulation<sup>2</sup> and the discretionary powers it gives to the EU will provide it with enough room for these margins and duties to be adjusted.

The **political and economic fallout** that would almost certainly occur if China does not get what it sees as its right under its WTO Protocol of Accession could have serious consequences for EU companies, and EU-China economic relations in general.

With the above in mind, **the FTA calls upon the EU to accept that Section 15 of China's Protocol of Accession does indeed grant it market economy status** in the limited area of calculating normal value in anti-dumping investigations as from 12 December 2016.

## 6. WHAT NEXT? WAYS FORWARD TO IMPROVE BILATERAL TRADE RELATIONS

In view of China's outstanding importance as an economic partner for Europe it is our core objective to promote economic opportunities and to limit the risks. In order to create a business environment that is even healthier for both the EU and China, the FTA would like to make the following recommendations:

- 1) **PERCEPTION:** The European retail sector encourages the EU to more proactively **acknowledge the vital role of imported products** from third countries and to put more emphasis on the added-value of Chinese imports for the European economy in official publications and political declarations.
- 2) **INCREASED COOPERATION:** Both entities should **intensify cooperation between enforcement authorities**. EU and China have a common interest in streamlining their cooperation and work together towards harmonising customs practices, improving IPR protection, and ensuring a transparent legal environment.
- 3) **BILATERAL INVESTMENT TREATY:** FTA calls on the EU and China to progress with the ongoing negotiations of the investment agreement to **reach a deal by end 2016**. A strong market access chapter and efficient implementation tools should be included, with a built-in **company-state arbitration court** to challenge investment and markets access obstacles.
- 4) **FREE TRADE AGREEMENT:** FTA welcomes the initiative by President Xi Jinping, **encouraging the opening of negotiations for a comprehensive EU-China free trade agreement**. Since China's middle-class and consequently average income is growing, a bilateral trade agreement could be of significant importance for generating future demand for European products. Further discussions are needed to guide progress on this subject.
- 5) **MARKET ECONOMY STATUS:** China aspires to receive Market Economy Status (MES) at the end of 2016. The European Union and the United States of America are both considering the change in status, but remain vague about their intentions. FTA incites the **EU to make further efforts for supporting China's transition** to a market economy by granting it MES.
- 6) **CHINESE REFORM AGENDA:** The FTA welcomes the ambitious reform agenda by the Chinese leadership and, if correctly implemented, it will make **considerable changes to the economic direction of China**. The ultimate goal remains to shape a more business-friendly and competitive environment for foreign companies.
- 7) **TAIWAN:** In parallel to strengthening the EU-China commercial relations the EU should not neglect the importance of Taiwan as a leading economic power in the East Asia region and beyond. The EU and Taiwan should take concrete steps to **begin talks on an investment agreement** as soon as possible.

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<sup>2</sup> Council Regulation (EC) No. 1225/2009 on protection against dumped imports from countries not members of the European Community

- 8) **HONG KONG:** Due to today's business reality of increasingly interlinked regional supply chains, businesses in east Asia would greatly benefit from a wider regional network of investment agreements. For this reason, **the EU and Hong Kong should set a timeline for launching negotiations on an investment agreement** in the near future.
- 9) **MULTILATERAL:** FTA calls upon the EU and China to use their power as major economic players to **conclude the stalled WTO Doha Round**, even if the outcome would be less ambitious than initially intended. Following this, a new round with fresh and updated objectives should be kicked-off. The EU should also continue promoting the inclusion of China into the group of countries negotiating the Trade in Services Agreement (TiSA).

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*The Foreign Trade Association (FTA) is the leading business association of European and international commerce that promotes the values of free trade. We bring over 1700 retailers, importers, brands and national associations to improve the political and legal framework for trade in a sustainable way.*



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## ANNEX: LIST OF MAIN LEGAL AND PROCEDURAL OBSTACLES IN CHINA

	Obstacle	Problem description	Specific impact
OUTLET OPENING	<b>Approval process</b>	<ul style="list-style-type: none"> <li>Measures imposing discriminatory approval requirements constitute an important obstacle to foreign investment, especially if requirements do not apply to domestic investors.</li> <li>Local authorities tend to favour domestic companies when allocating retail outlet licenses and premium real estate locations.</li> </ul>	<ul style="list-style-type: none"> <li>Licensing for retail outlet opening appears to be tightly controlled and lacks transparency.</li> <li>In addition, lack of predictability.</li> </ul>
GARMENTS	<b>Sampling</b>  (Procedures by the CIQ, Quarantine Inspection Bureau)	<ul style="list-style-type: none"> <li>Chinese authorities take samples from almost all (!) shipments for quality and safety testing.</li> <li>Testing results by foreign laboratories are not allowed.</li> </ul>	<ul style="list-style-type: none"> <li>Tests are abnormally expensive.</li> <li>Major delays for shipments affected by sampling; the commercialisation of these goods is delayed by a minimum of two weeks.</li> </ul>
	<b>Labelling</b>  (Based on GB ( <i>Guo Biao</i> ) National Standards)	<ul style="list-style-type: none"> <li>Extremely difficult and burdensome labelling requirements.</li> <li>Multitude of codes to be defined in addition to the standard codes (e.g. size codes, special Chinese size codes, direct skin contact, indirect skin contact).</li> </ul>	<ul style="list-style-type: none"> <li>Heavy burden for importers in their procurement operations and cost structures.</li> <li>Refusal of import permission in case of false labelling which happens frequently due to the opaque regime.</li> </ul>
	<b>Testing</b>  (GB National Standards issued by the SAC, Standardisation Administration of China)	<ul style="list-style-type: none"> <li>The GB National Standards system is characterised by a high level of complexity.</li> <li>To determine the valid “GB standard code” (which determines the required testing regime) for an imported product a multitude of parameters have to be taken into account (e.g. type of product, composition of fibre, age-group, gender).</li> <li>Example: The assignment of a non-denim GB standard code to a denim product will automatically lead to a “fail” result, even if the product is safe.</li> </ul>	<ul style="list-style-type: none"> <li>This complex system is leading to unnecessary administrative burdens and a high level of false assignments.</li> <li>With the exception of labelling errors, for most types of fails all garments of the same shipment need to be destroyed. This is very drastic and unproportioned measure.</li> </ul>



	<b>Obstacle</b>	<b>Problem description</b>	<b>Specific impact</b>
<b>PROCEDURES</b>	<b>Customs</b>	<ul style="list-style-type: none"> <li>• The import procedures are complicated and overly bureaucratic.</li> <li>• Regulations and procedures in the different entry ports are not harmonised.</li> <li>• Customs and CIQ declarations are limited to just 20 lines each which poses a manifest problem for large consignments.</li> </ul>	<ul style="list-style-type: none"> <li>• Local import authorities have a high level of discretionary power which inevitably leads to unequal treatment and lack of predictability and transparency.</li> <li>• Bigger import volumes need to be divided into smaller batches causing delays and extra costs.</li> </ul>
<b>IPR</b>	<b>Enforcement of IPR policies</b> (Patent Law, Trademark Law and Copyright Law)	<ul style="list-style-type: none"> <li>• Even with comprehensive intellectual property laws that meet international standards, IPR violations and counterfeiting remain a very pressing concern.</li> <li>• The main obstacles is the poor level of implementation of existing laws and procedures.</li> </ul>	<ul style="list-style-type: none"> <li>• China is the country where most counterfeited products originate and the most IPR violations happen.</li> <li>• In 2013, 64 % of products confiscated due to IPR infringements on the EU borders came from China.</li> </ul>