What are the real reasons for trade imbalances?

When Chinese political leaders were recently asked about China's big trade surplus with Europe, they gave this answer: Remove obstacles to high-tech exports. That will bring down your trade deficit. Another answer we often get from the Chinese side when we talk about rising protectionism in China is this one: We are not protectionist. China has simply become more competitive, live with it! These answers are given when China plays on the offensive. The third answer, when China plays defense, is this one: We are still a developing country, you cannot expect us to open our markets too quickly.

No doubt, trade frictions will play an important role when the top leaders of China and the United States will meet this week. In principle, there are three basic methods on how to deal with trade problems: One is to leave things basically as they are, because there are no significant restrictions in place. Deficits and surpluses are a result of fair competition. This is basically the situation between Germany and other countries such as its trade partners within the EU and with the US, although there is always room for further improvement through trade agreements such as TTIP. A second way would be for "deficit countries" to restrict exports coming from "surplus countries" through tariffs and other coercive means. This is the mercantilist approach of 17th and 18th century pre-industrial Europe. The third one consists of removing barriers to trade that distort fair competition, such as high tariffs and non-tariff barriers on both sides. This is the win-win-solution because it allows more growth for trade in both directions. While becoming export world champion since 1949, Germany has consistently had the experience that this is the only rational option: reciprocal openness.

Trade between Germany and China used to be almost balanced. In recent years, it has shifted in China's favor, with a German trade deficit of around 17,5 billion Euros in 2016. Compared to our burgeoning trade, which increased to 170 billion Euros, this is significant but not extreme. The picture looks much bleaker for basically all other European trading partners of China. France had a deficit of around 30 billion Euros and the UK a whopping 27 billion Pounds (i.e., trade in goods) in 2016. The imbalance is strongest amongst China's so-called 1+16 partners in Central and Eastern Europe. China's exports to Poland are almost ten times bigger than its imports.

Are these imbalances the result of European restrictions of high-tech exports to China? Unlike in the United States, European export controls only concern military hardware and dual use goods. The extremely low levels of East European exports to China are clearly not due to high-tech-export restrictions.

The real obstacles to European exports to China lie elsewhere. They are threefold:

1.- High tariffs:

China has not lowered tariffs significantly in the last five years. In selected strategic industries such as cars, import duties are astronomically high. only about 5% of cars in China are imported; Germany imports more than a third of its cars despite having the world's strongest car industry.

2.- Non-tariff barriers:

China has not significantly lowered its non-tariff import barriers in recent years. In crucial fields it is even raising them. Food imports are maybe the most strident example. The government is

relentlessly pressing ahead with a food certification system that will cover not just risk foods such as meat and fresh milk but -all- foods. Against WTO recommendations and a chorus of protests by all its trading partners, that this would, in many cases, make food exports to China prohibitively expensive, China insists on demanding "food safety" certification for every chocolate bar, every noodle and every juice bottle in the future. This threatens to set back China's trade relations with all its European partners, especially those that want to redress extreme imbalances in their trade with China in Eastern and Southern Europe. This will hurt independent farmers and jobs in those countries. The infrastructure projects pushed and financed by China can hardly compensate for these losses and will likely further increase the trade imbalance.

3.- Lack of predictability, rule of law and intellectual property protection:

There are indeed barriers to more high-tech trade with China. However, they are not European restrictions but obstacles created by the Chinese side. European companies – including those working on changing manufacturing with Industry 4.0. applications– actually want to export high tech to China and invest here. However, with regard to effective protection from intellectual property theft, they lack trust in China. Still today, we see whole copycat factories springing up in China. Foreign investors share this lack of trust with their Chinese peers, who are also in need for better enforcement as their products are becoming more and more sophisticated. The backlog of IPR cases in the Chinese courts is huge and we hear from companies involved that the decision making process is not free from outside interference. The lightning speed with which Trump-related trademark cases were resolved en masse should be a precedent for countless cases still languishing in the courts.

Another factor that creates strong uncertainty is an unabated trend by some Chinese government departments to put pressure on foreign companies to transfer technology and know-how. For example: by putting pressure on foreign investors to form joint ventures as a minority partner even when it is not required by law, or intrusive information demands on production processes at home before granting import licenses in the processed foods sector, or by using unrelated procedures such as merger & acquisition approvals as a lever to demand technology transfer. I still frequently hear complaints about forced technology transfer when German companies talk to me about the challenges of doing business in China. This is not limited to the automotive industry, which accounts for over 50% of Germany's investments in China, but applies across the board in manufacturing. This has given rise to doubt about what the "Made in China 2025" strategy is meant to achieve. Is it meant to propel China into the future of high-tech globalisation or a tool to retrogress to old concepts of "self-strengthening", i.e. for China to go it alone?

Aside from these individual challenges, German companies ask questions about the underlying trend. So far, there have not been any significant steps towards further opening China to foreign trade and investment. We have seen a few measures, such as the opening of a few minor and not very lucrative fields for investment. However, these seem to be more strongly geared towards facilitating *outward bound* trade and investment, such as the new free trade zones. Those zones have so far not been effective in reversing negative trends in trade and foreign investment.

Fortunately, there are also encouraging developments. Since January, positive signals such as President Xi's Davos speech and new decisions by the State Council and the Central Leading Small Group for Comprehensively Deepening Reforms are multiplying. Premier Li Keqiang's clarification, given at this year's National People's Congress, that foreign invested enterprises will be able to compete on a level playing field in the implementation of "Made in China 2025", was timely and

welcome. These are the right policy choices. If they are implemented rigorously, the Sino-European economic partnership will greatly benefit. It will probably become more competitive, but at the same time also increasingly integrated. One crucial step towards even closer integration and at the same time fair competition between China and Europe would be a swift conclusion of the EU-China Comprehensive Agreement on Investment. Once we get close to the finish line, we could accelerate steps towards a free trade agreement. These two steps would not only bind us together as economic partners to huge mutual benefit, it would also send a powerful signal around the world. The effects would go far beyond the trade sphere. They would maybe be the best contribution Europe and China could make for a cooperative, win-win and stable 21st Century.