# Europe's China Syndrome

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Chinese premier Li Keqiang is in Brussels on Tuesday for the 21st EU-China summit, and the talks are likely to be testy. After much dithering and in response to much pressure from Washington, the EU has begun to take a more hardline posture towards China. This is evident in a European Commission strategy document published March 12 that labels China a "systemic rival," and in a new foreign investment screening regime taking effect this month whose main intent is clearly to limit China's ability to acquire European technological assets.

The core European countries (Germany and France) and the Brussels Eurocrats share many of the concerns that motivate the US trade war with China. Europe relies heavily on exports to China, but runs a significant trade deficit (exports were €198bn and imports €375bn in 2018). European firms have long complained about Chinese subsidies for domestic companies that create excess capacity and undermine the ability of foreigners to compete.

The EU has a littany of complaints about Chinese business practices, and fears the acquisition of its technological champions

And as in the US, a wave of Chinese investment has prompted fears that large swathes of the European technological base will fall under Chinese ownership. It also spurs complaints of unfairness, since China's restrictive foreign investment laws make it impossible for European companies to make similar acquisitions in China.

The concerns are especially acute in Germany, which has received US$22bn in direct investment from China since 2000, second in the EU only to the UK (US$47bn). Moreover, in recent years Chinese investment has targeted Germany's treasured Mittelstand: since 2014, Chinese investors have acquired or bought stakes in nearly 100 small and medium sized German mechanical engineering firms, in every state, according to Berlin-based consultancy Sinolytics.

## Checking The Boxes

Our short take on the latest news

| Fact | Consensus belief | Our reaction |
|---|---|---|
| **NY Fed survey of 1y consumer inflation expectation rose to 2.82% in Mar**, from 2.79% | N/A | No sign of inflation outburst; stable outlook allows the Fed to keep rates unchanged |
| **German exports fell -1.3% MoM in Feb**, from 0.1 in Jan | Below -0.5% exp.; imports fell -1.6% MoM, from 1.4%; 3m CA surplus at 7.4% of GDP | PMIs continue to paint dismal picture, but stabilizing Chinese growth should benefit Germany |
| **Banque de France industrial sentiment unchanged at 100 in Mar** | Slightly below 101 exp.; BdF 1Q GDP f/c 0.3% QoQ, slightly lower than INSEE 0.4% f/c last month | GDP f/c points to growth holding up even though PMIs have averaged below 50 in 1Q |
| **Taiwan exports fell -4.4% YoY in Mar**, from -8.8% in Feb | Higher than -8.3% expected | No clear sign of recovery in Asia trade yet; stabilization in China should help support exports |

An informal toughening of investment reviews in Germany, along with tighter controls on outbound capital in China, have already led to a contraction of Chinese direct investment in Europe, to €17bn in 2018 from over €37bn just two years earlier. The new EU screening rules will further crimp Chinese investments, especially in technology sectors; and Europe's tougher line will add to the pressure for China to make meaningful concessions on market access in its forthcoming trade deal with the US.

Despite its grievances, the EU has little appetite for a confrontation with China

But there are limits on how far the EU is willing or able to pressure China, due to reasons of commercial interest and institutional fragmentation. Europe's economic cycle is significantly driven by exports to China, and the eurozone's trade dependency has only deepened now that unconventional monetary policy has reached the limits of its effectiveness and the fiscal compact constrains governments from stimulating domestic demand through bigger budget deficits.

Major European companies depend heavily on China for growth. The 30 companies in the DAX index derive 16% of their sales from China, and for firms like BMW, Daimler, Volkswagen, BASF and Infineon the number is closer to a quarter. BASF plans to invest more than US$10bn in two big new chemical plants in China, and BMW is plowing more than US$3bn into an expansion of its Chinese joint venture. Engineering and equipment firms such as Siemens and ABB see China's Made in China 2025 technology upgrading plan not as a threat, as it is often portrayed in the US, but as a rich source of contracts. With these vast commercial interests at stake, Europe's appetite for direct conflict with China is limited.

The recent EU strategy paper downplayed tensions with China

This reluctance shows in the EC's China strategy paper. Headlines highlighted the "systemic rival" phrase, which echoes earlier US policy documents labeling China a "strategic rival" (see **How Much Risk Of A US-China Economic Cold War?**). But the paper actually calls China "a cooperation partner with whom the EU has closely aligned objectives, a negotiating partner with whom the EU needs to find a balance of interests, an economic competitor in the pursuit of technological leadership, and a systemic rival promoting alternative models of government."

With such mixed objectives, Europe is likely to follow the US lead only spottily. Recently, for instance, Germany and other European countries have pushed back hard against Washington's efforts to get them to ban Huawei from supplying their 5G telecoms networks. On the other hand, the European Bank for Reconstruction and Development (of which China became a shareholder in 2016) has quietly shelved plans to co-finance Belt and Road projects with Chinese policy banks, thanks to US pressure.

EU fragmentation limits the severity of any curbs on Chinese investment

Europe's second constraint is its institutional fragmentation. This vitiates the new FDI screening mechanism. The European Commission will identify foreign state-supported investments in key technologies and critical infrastructure, and flag any that might threaten Europe's "security, public order and strategic interests." According to German think-tank MERICS, as much as 82% of China's 2018 M&A activity in Europe could have been identified under these rules.

China has the opportunity to adopt a divide-and-rule strategy towards Europe

But the decision to intervene is left with individual EU governments rather than at the EU level. This gives China an opportunity to divide-and-rule by inducing economically weaker EU states to give them a free hand in investments. This risk is already evident in China's heavy investments in the so-called "16+1 group" of central and eastern European countries (with China as the plus-one), and in Italy's recent decision to formally sign on to the Belt and Road Initiative. China is also currying favor with France, via a much bigger than expected Airbus order. A potential loophole in the investment screening mechanism is that a wholly-owned Chinese subsidiary in Italy or Belgium that then tries to take over a German firm might not be subject to restrictions, since the acquiring firm would be an EU company rather than a foreign one.

One final risk of the intensifying European anxiety over China is that it encourages the EU to fend off China's predacious national champion firms by building its own through industrial policy (see **The Trouble With Champions**). This is likely to exacerbate, rather than solve, Europe's productivity problems.