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Eight Potential Roadblocks to Smooth EU-China Economic Relations

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For about two decades, economic relations between the European Union and China developed impressively and, putting aside episodic sectoral tension, without causing major dispute. For the European Union, China has become the first source of imports and the fourth largest export market (behind the United States, Switzerland, and Russia). Likewise, for China, the European Union has become the second source of imports (behind Japan) and the second largest export market (behind the United States). Although EU-China bilateral trade has been permanently imbalanced in favor of China, the situation did not raise significant concerns among European policymakers until recently. European foreign direct investment (FDI) to China has also developed substantially over the last decade to reach some €6 billon in 2005, and the European Union has become one of China's most important investment partners.

The smooth development of EU-China relations contrasts with the emotional, generally politicized, and sometimes tense character of US-China relations. In fact, those relations have only recently become a matter of

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public interest in Europe.[1] Before, the international rise of China and its global economic implications had long remained almost unnoticed—and certainly underestimated. In the 1990s and early 2000s, political energy was essentially devoted to addressing internal issues such as the creation of the Single Market and the euro or EU enlargement. An illustration of this apparent neglect was the fact that Europe's new economic strategy (the "Lisbon Agenda") adopted in 2000 essentially ignored the opportunities and challenges posed by China's growth and development.

Perceptions have changed, and initial inattention is quickly being corrected. At the political level, the EU-China annual summit has gained prominence on the diplomatic agenda. The bilateral trade relationship has attracted growing attention, especially after the lifting in 2005–07 of trade restrictions inherited from the Multi-Fiber Arrangement. Europe's longstanding indifference toward Chinese exchange rate policy has also ended, as illustrated by the joint visit to Beijing in November 2007 by the president of the euro area's Council of Ministers, the president of the European Central Bank (ECB), and the Commissioner for Economic and Monetary Affairs. Nevertheless, European interest in and concern about China remain strikingly less intense than US fascination with it.

The thesis of this chapter is that such a situation is paradoxical given the intensity of the bilateral relationship and the fact that China's development represents an even more significant economic challenge to Europe than to the United States. We certainly do not dispute that this relationship creates trade and investment opportunities for Europe as well as China. Yet we point out that it would be unwise to ignore its challenges and the corresponding potential roadblocks on the way to the development of smooth economic relations between China and the European Union. It is only by clearly identifying those challenges, by addressing them explicitly, and by developing a far-reaching dialogue on the possible risks and appropriate responses that policymakers on both sides can reap the full potential of EU-China relations.

We identify eight channels through which China's growth is bound to affect Europe in a distinctive way:

1. Europe's industry is at risk of being squeezed between the United States and China.
2. Dysfunctional European labor markets add to the adjustment cost.
3. Chinese integration into the world economy may interfere with the process of European integration.
4. European privileged trade relations are being destabilized by Chinese competition.

1. The first EU policy paper on China was issued in 1995, almost two decades after the Chinese economy had started to transform, and the first EU-China summit meeting took place in 1998. See Barysch (2005) for an overview of the development of EU-China relations.

5. China's effort to secure access to energy and raw materials affects an import-dependent European Union.
6. Europe's and China's stances on climate change may result in conflict over greenhouse gas emissions containment and its trade implications.
7. The euro exchange rate risks being the ultimate adjustment variable.
8. China's rise to world economic power status is bound to reduce Europe's weight in the governance of international organizations.

Some of those channels are specific to Europe; some others affect other countries too. The origins of Europe's particular position are not identical either across the eight channels; they include its economic situation and institutions, its policies, and its integration process. Addressing the corresponding problem should in some cases be the task of European or Chinese policies; in others it could be the focus of joint action between China and the European Union, and in still others it is beyond the reach of policy actions and Europeans must simply adjust to reality.

What is certainly specific to Europe, however, is the coexistence of those eight potential roadblocks. This is why we claim that policymakers from both sides should reflect on the corresponding challenges and address them explicitly rather than ignore them.

We take the channels one by one and for each briefly discuss the issue, the risks, and the policy options. We offer general conclusions at the end of the chapter.

Europe Is at Risk of Being Squeezed Between the United States and China

In spite of its claims and hopes, the European Union is far from being a knowledge-based economy. It is even far from being en route to becoming one. While the United States has moved decisively toward becoming a high-technology, service-based economy, the European Union's economic strength and comparative advantage remain in manufacturing. Some of the EU member states still remain specialized in low-technology manufactures (table 10.1).

Several other indicators confirm that Europe has not yet embarked on the kind of transformation the US economy has been undergoing for well over a decade.

First, manufacturing[2] (OECD 2004) still represents about 30 percent of total employment in the European Union (EU-27), against 20 percent in the United States. Its share in employment and value added is especially

2. Manufacturing also includes mining, electricity, water, and construction.

Table 10.1 Export specialization index, selected countries

	Technological intensity				
Country	High	Medium-high	Medium-low	Low	Information and communication technology
United States	1.4	0.9	0.7	0.8	1.5
EU-15	0.9	1.0	1.1	1.1	0.8
Germany	0.8	1.2	1.1	0.7	0.7
France	0.9	1.0	1.0	1.1	0.7
United Kingdom	1.5	0.8	0.8	0.8	1.5
Italy	0.5	0.9	1.3	1.7	0.3
Spain	0.4	1.1	1.3	1.3	0.4

Note: The export specialization index is the ratio of the share of a given product in the country's exports to the share of the same product in OECD exports. It is an indicator of revealed comparative advantage.

Source: Organization for Economic Cooperation and Development Structural Analysis (STAN) database.

high in Germany and the new member states of Central and Eastern Europe. Furthermore, productivity growth in Europe still largely depends on the performance of the manufacturing sector. Unlike the United States, recent years have not witnessed the emergence of high-productivity service sectors that could replace manufacturing as engines for growth. Europe's economy thus remains much more rooted in manufacturing than that of the United States.

Second, European R&D still represents only about 2 percent of EU GDP and has not yet started to increase despite the repeated political commitment to raise it to 3 percent under the Lisbon Agenda. At the same time, the proportion of the population of working age with tertiary education remains below one-fourth, against more than one-third in the United States. With total (public and private) EU spending on tertiary education remaining around 1½ percent of GDP (against almost 3 percent in the United States), investment in education is well below what would be required to bridge the gap (OECD 2007).

What this means is that unlike the United States, Europe has demonstrated a limited ability to develop a new comparative advantage based on knowledge and innovation. As China develops and moves away from traditional low-skill sectors toward more skill- and research-intensive sectors, Europe's traditional comparative advantage is being eroded. This is exactly the type of situation in which the Samuelson (2004) argument has relevance. While it is wrong to claim that the erosion of a country's traditional comparative advantage implies an income loss if new comparative advantages simultaneously emerge in other sectors, it is true that a country whose comparative advantage is being eroded faces an income loss if it does not move ahead and change its production mix. This is precisely

the situation for Europe, or at least parts of it: While Germany's strong comparative advantage in equipment goods enables it to benefit from China's demand for them, countries like Italy and Spain do not enjoy the same comparative advantage.

Turning to policy implications, the Europeans should obviously not blame China for their own inability to transform themselves and reinvent their comparative advantage. The response strategy should, to a very large extent, be the one they defined at Lisbon in 2000: invest massively in knowledge and education, focus on innovation, and make the economic system better equipped for change. Unfortunately, so far there has been too little action on this front.

The rise of China therefore reinforces the necessity to transform the European economy and makes procrastination more costly and less acceptable.

Dysfunctional European Labor Markets Add to Adjustment Cost

For trade gains to materialize, factors of production need to relocate to new sectors in which the European Union can exploit its comparative advantage. This process is never as smooth as in the textbook case of perfectly competitive markets for capital and labor since it always involves adjustment costs. The magnitude of these costs depends on the quality of domestic institutions—the functioning of labor, product, and capital markets.

The problem for Europe (or at least for the large continental economies of the EU-15) is that the functioning of labor markets—and of product, housing, and capital markets as well—is not conducive to adjusting international specialization.

Continental European labor markets are notoriously dysfunctional when it comes to ensuring the relocation of displaced workers. Workers who approach the retirement age—a frequent situation in traditional industries such as textile, apparel, and light manufacturing—are generally unlikely to find another job because there is virtually no labor market for people over 55. A series of comparative studies of France, Germany, Spain, and the United States in the 1990s found that the probability of reemployment for a low-skilled worker over 55 was at least six times lower in Europe than in the United States (Pisani-Ferry 2000). Thus when a plant that employs middle-aged, low-skilled workers in a small city closes, a large number of the workers end up permanently unemployed. Recent EU efforts to increase the participation and employment rates of older workers and get rid of early retirement schemes have produced results in many member states: The employment rate of "older workers" (aged 55–64) in the EU-27 increased from 37 to 43 percent between 2000 and 2006. Nonetheless, the EU rate remains far behind the levels in Japan or the United States, where it is above 60 percent.

Even for prime-aged employees, empirical evidence suggests that the cost of losing a permanent job is substantial. In France, Margolis (2000) reckons that, on average, workers laid off from a permanent job because of industrial restructuring remain unemployed for more than six months and that those who do not find a new job quickly typically lose one-fourth of their wage income (one-half for women). Those who take a new job in another place also take on the costs related to access to subsidized housing and public services. Furthermore, public policy is generally not effective in redistributing trade gains to those on which the burden of adjustment falls.

The problem is not limited to labor markets. European product and credit markets are not conducive to adjusting through the creation and growth of new businesses. The OECD (2003) has shown that while the birth and death rates of new companies are roughly the same in Europe and the United States, after a few years the typical newly founded European company has barely increased the number of employees on its payroll, whereas the typical new US company has doubled in size. In other words, the process of adjusting to economic change is much slower in Europe than in the United States. This means that adjusting to a change such as the development of China's production and export is often painful for European economies, even when they are poised to gain from restructuring their own production and foreign trade.

Governments in several EU countries have started to emphasize the functioning of the labor market, the incentive properties of unemployment insurance, and the quality of the match between labor supply and labor demand. The accepted slogan is that public policies should equip people for economic change and assist them in coping with it, rather than prevent change. "Flexicurity," which promotes a combination of flexible labor markets and a high level of employment and income security, is often seen as the answer to the European Union's dilemma of how to maintain and improve competitiveness while preserving its social model(s). However, many continental European countries are still some distance from reinventing their economic institutions to adapt to a fast-transforming world economy.

In 2007 the European Union introduced the European Globalization Adjustment Fund to provide labor market support to trade-displaced workers. Although, like US trade adjustment mechanisms, the new fund is fraught with problems (Wasmer and von Weizsäcker 2007), it is nonetheless a step in the right direction, helping to make market opening politically sustainable and avoid a backlash against the hardships of globalization.

Chinese Integration into the World Economy May Interfere with European Integration

The recent European enlargement has greatly increased economic disparities in the European Union, and further EU enlargement, to the western

Table 10.2 Export specialization index, Central and Eastern European member states of the European Union

Country	Technological intensity: High	Medium-high	Medium-low	Low	Information and communication technology
Czech Republic	0.6	1.1	1.6	1.0	1.0
Hungary	1.2	1.0	0.7	1.0	2.0
Poland	0.3	0.8	1.9	1.7	0.4
Slovakia	0.2	1.1	2.0	1.2	0.3

Note: The export specialization index is the ratio of the share of a given product in the country's exports to the share of the same product in OECD exports. It is an indicator of revealed comparative advantage.

Source: Organization for Economic Cooperation and Development Structural Analysis (STAN) database.

Balkans and beyond, is on the agenda for the years ahead. Making the enlarged Europe of 27 countries an economic, and not only an institutional, reality is now a priority. The new member states are expected to catch up, over time, with the older ones, but this process is bound to take several decades. In the meantime, the European Union is going to be in transition, and a significant part of its energy will be absorbed by its own integration.

This integration process is bringing together rich, mature economies and new member states that can be characterized as relatively well endowed in human capital but poor in physical capital. Export specialization indices confirm that the new members' comparative advantages differ significantly from those of the old member states; this is especially the case for Poland and the Slovakia (table 10.2). The integration process will thus involve the relocation of labor-intensive industries to the new member states and the emergence of a new division of labor across Europe. However, it does not take place in an international vacuum. China shares some of the characteristics of the new member states: It is capital-scarce but has a very elastic supply of unskilled labor, and while it is relatively less well endowed in skilled labor than the new EU member states, it is fast increasing its stock of skilled labor.[3]

To some extent, therefore, China and the new member states are competing locations for investment from the capital-rich old EU members. This is the viewpoint of many European policymakers, who tend to see enlargement as an opportunity to improve European competitiveness in the face of globalization. They point to the transformation of German industry and its successful relocation of the most labor-intensive production segments in the new member states, which have helped Germany recoup its

3. Farrell et al. (2005) provide interesting data on the supply of skilled labor in major emerging regions and discuss the potential for offshoring.

position as the world's number one exporter. In this way, enlargement or, more precisely, economic integration in the enlarged European Union can be regarded as a response to the pressure of globalization. But public opinion in the old member states tends to regard enlargement and globalization as two mutually reinforcing transformations that result in an accelerated relocation of jobs. Viewed in this way, the strains of enlargement reduce the political tolerance to the strains of globalization—and vice versa.

The response to this challenge belongs again to the European Union. Successful economic integration of the new member states may be conducive to an improvement in the overall competitiveness of the European Union. For this to happen, however, the comparative advantage of the new member states needs to be exploited in full, and their catching up needs to be supported by EU policies. In such a scenario, accelerated growth and catching up would make tangible the notion of a positive-sum game from which both old and new member states can expect to gain (as in fact happened in the 1980s and the early 1990s with enlargement to Greece, Portugal, and Spain). It would also favor external liberalization. A less favorable scenario, however, could heighten fears and make the European Union less able to cope with the globalization challenge.

Chinese Competition Is Destabilizing Europe's Privileged Trade Relations

More than the United States and Japan, the European Union has created a network of bilateral and regional trade agreements that give partners preferential access to its market. Over the last two decades, trade policy has been used as an instrument of political or development aims—especially as the European Union has responsibility for trade policy but lacks other instruments to conduct foreign policy. Trade agreements have been signed with countries that aimed to join the European Union but were not considered legitimate candidates, with ex-colonies, and with countries in which the European Union intended to express positive interest. The result is an impressive web of preferential trade agreements (Sapir 1998).

With developing partners, these agreements embody a commitment from the European Union to contribute to their development. For example, economic partnership agreements (EPAs) with African, Caribbean, and Pacific (ACP) countries aim at encouraging trade both with the European Union and among the developing-country partners. Several countries (e.g., in the Mediterranean region) have effectively tied their development strategy to the preservation of privileged access to the EU market.

Beneficiaries of such preferential trade agreements generally tend to resist multilateral trade liberalization or at least try to slow it down. Their reluctance is likely to be heightened by the risk of seeing their exports to

the European Union substituted by more competitive Chinese exports, as is the case with textiles and clothing.

In the Doha Round, the European Union has come under pressure from China and other G-20 countries to liberalize its market on a multilateral basis and from ACP and other G-90 countries to preserve their preferential treatment. It remains to be seen whether and how the European Union will manage to satisfy both groups.

Contrary to the past EU-ACP trade agreements, which provided only for nonreciprocal preferential access to the European market, the new EPAs also give EU exporters preferential access to ACP markets. Although the reciprocal nature of these agreements was essentially imposed by the need to bring the EU-ACP trade relationship in line with WTO rules, it also serves EU interests well, as EU exporters enjoy a substantial preferential margin over their competitors given that tariff levels tend to be quite high in ACP countries. This may help the European Union to counter China's growing trade and investment influence in Europe's former colonies, especially in Africa (concern about the rapid expansion of China's economic relationship with Africa was certainly a key driver of the EU-Africa summit in Lisbon at the end of 2007, the first such summit in seven years).

China's Strong Demand for Energy and Raw Materials Affects Import-Dependent European Union

In recent years, China's emergence as a major importer of energy and raw materials has had significant effects on world markets. From 1995 to 2005, its demand for energy accounted for 32 percent of the growth in total energy demand, whereas Europe accounted for only 11 percent.[4] According to the International Energy Agency, China's demand for energy should continue to grow in the years ahead and more than double between 2005 and 2030 (IEA 2007). The same applies to other raw materials, for which China's share increased from 0.7 percent of world imports in 1985 to 6.4 percent in 2005 (Lemoine and Ünal-Kesenci 2007). Overall, China's share in these markets is strongly affected by its demand.

As a major importer, Europe is obviously affected by the increase in the relative price of energy and corresponding deterioration of its terms of trade. China's development is therefore often considered a threat to Europe's own growth and income. Europe, it is feared, could lose out from changes in relative prices resulting from China's emergence.

But casual analysis can be seriously misleading. While it is correct to point out that China's emergence resulted not only in a global supply shock to the market for manufactures but also in a global demand shock

4. Based on data from the US Energy Information Administration.

to the market for raw materials, the pessimistic view overlooks China's impact on Europe's terms of trade, which can be assessed only in a general equilibrium setting: China's supply of cheap manufactures and its demand for expensive European products have to be taken into account also. Interdependence through changes in relative prices is a feature of the world economy, and the European Union would have little ground for complaining about the rise in the price of raw materials without considering the benefits of cheaper imports and an increased demand for its own products. We are not aware of studies that provide a comprehensive assessment of China's impact on European incomes.

It is true that (1) the effects of China have been staggered, with the drop in the price of manufactures coming first and the rise in the price of raw materials second, and (2) as always with changes in relative prices, the impact of this shock differs across countries and individuals, leading to a redistribution of income.

Another related issue is energy security. In recent years, China has developed an effort to secure access to oil and other sources of energy through a series of bilateral agreements. The issue here is whether the combination of higher world demand for energy and China's supply policy in some way threatens the European Union's own security.

There are two ways to promote secure access to energy, raw materials, and food. One is to rely on the depth of open markets and on multilateral rules and institutions designed to accomplish the proper functioning of these markets. The other policy is to rely on self-insurance through the accumulation of reserves or bilateral deals with selected partners. According to this approach, economic security requires investing in the development of arrangements that can be activated when appropriate.[5] Both solutions are hardly compatible in a tight market, because recourse to bilateral or unilateral arrangements reduces the depth of markets and therefore the security of the countries that primarily rely on it for ensuring their supplies.

In the last decades, the oil market has evolved in the direction of the first model, while bilateral agreements tend to predominate for natural gas, for which infrastructure and transport costs are much higher. This is true also for Europe, which relies on the global market for its oil supplies but has entered into agreements with Russia and developing countries to ensure continued access to gas reserves. But as observed by Coby van der Linde (2007), the European Union lacks the instruments of a state and therefore prefers market-based solutions, whereas individual member states can also rely on the traditional instruments of energy diplomacy.

5. Financial security can be analyzed along the same lines. Some countries choose to rely on the depth of the global financial system and the insurance provided by multilateral financial institutions; others prefer to build self-insurance through the accumulation of reserves and the securing of specific deals with private or public financial institutions.

China meets its growing oil demand on the open market as well but at the same time also relies on bilateral oil agreements. These are not likely to undermine the functioning of the global market or the energy security of the European Union, but a significant shift toward bilateral agreements could trigger reactions from other countries and contribute to changing the pattern of world oil supplies.

The issue deserves a serious forward-looking dialogue between the European Union and China, in which both partners could spell out their views on the future of energy and raw material markets, discuss corresponding securities issues, and envisage potential cooperation. Candid dialogue would be preferable to suspicion.

Europe's and China's Stances on Climate Change May Result in Conflict over Emissions Containment and Its Trade Implications

The European Union has for a long time advocated the reduction of greenhouse gas emissions, but it is only in the 2000s, when the Bush administration backtracked on previous US commitments, that it has taken the lead in pushing for international agreements on climate preservation. Its efforts resulted in the ratification and entry into force of the Kyoto protocol in 2005 despite the opposition of the United States and (at the time) Australia. In 2007 a further step was the unilateral commitment to reduce, by 2020, EU emissions by 20 percent (and by 40 percent in the framework of a concerted international endeavor). Already in 2005, a system of tradable quotas called the European Union Greenhouse Gas Emissions Trading Scheme (EU ETS) was put in place with a focus on energy-intensive industries.

China's perspective is very different. Although it is at risk of suffering significant damage from climate change, its major priorities remain economic development and job creation. Starting from a low per capita base, its total emissions are expected to overtake those of the United States by 2015 and to continue growing rapidly in the ensuing decades.

This creates two potential areas for conflict. The first, based on the sheer size of China, is that the effects of Europe's efforts are bound to be dwarfed by Chinese developments. This may lead to some European frustration and to disputes over the distribution of the burden of emission control.

The second area for conflict is commercial. Tough European measures (through regulation, emission control, or taxation) will inevitably affect the international competitiveness of European countries in certain sectors. Furthermore, the evidence is that because of specialization in capital- and energy-intensive industries, European countries are hardly "carbon-competitive" (Delgado 2007). A situation in which carbon-intensive in-

dustries would face competition from China or in which those industries would relocate to China would likely lead to trade disputes and amplified demands for a system of border adjustment taxes.

China and Europe may have convergent interests in the long run, but in the short run, their opposite stance on climate issues represents a significant risk to their relationship at both bilateral and multilateral levels.

Euro Exchange Rate Risks Being the Ultimate Adjustment Variable

The relationship between the euro and the renminbi exchange rate has long been a matter for specialists only. However, at end-2007, Europeans woke up to the issue and signaled dissatisfaction with the way the Chinese currency is run. This was illustrated by the high-level mission to Beijing in November 2007 headed by Eurogroup President Jean-Claude Juncker, ECB President Jean-Claude Trichet, and European Commissioner Joaquín Almunia.

From an analytical standpoint, the relationship between the euro and the renminbi has been the focus of studies whose basic arguments can be summarized as follows.

A first reasoning starts from the observation that the US dollar needs to depreciate in effective terms to get closer to equilibrium and correct the US current account deficit. According to this logic, rigidity in the renminbi-dollar exchange rate shifts the burden of adjustment to the countries that maintain a more flexible exchange rate, among which the euro is a prime candidate for appreciation. This may trigger a damaging overvaluation of the euro. This kind of reasoning is illustrated by Agnès Bénassy-Quéré and colleagues (2004), who discuss the burden sharing of adjustment among US trade partners and provide corresponding orders of magnitude.

A second reasoning starts from the capital rather than the current account. As long as China kept a fixed exchange rate vis-à-vis the US dollar, it had a strong motive for investing primarily its reserves in dollar-denominated assets. However, a move away from the dollar peg implies that private investors will replace the People's Bank of China (PBC)—in other words, that the Chinese investors' preference for dollar assets will diminish, or at least that the PBC will embark on a diversification of reserves, which has the same implications. This would lead to a higher demand for euro-denominated assets and therefore an upward pressure on the euro exchange rate. This kind of reasoning is put forward by Olivier Blanchard, Francesco Giavazzi, and Filipa Sa (2005), among others.

The difficulty with those approaches is not only that they are speculative in character but also that putting the two stories together leads to a "heads I win, tails you lose" situation. This is paradoxical since both approaches rely on the equilibrium exchange rate concept.

The solution to this apparent paradox is that the concept of an equilibrium exchange rate for the United States had little relevance in the so-called revived Bretton Woods system (Dooley, Folkerts-Landau, and Garber 2003). As long as the PBC was willing to accumulate as much dollar reserves as necessary to keep the peg, the relevant equilibrium exchange rate was that of the aggregate dollar zone, not that of the US economy alone. China's exchange rate policy had the effect not only of increasing Europe's share in the global exchange rate adjustment burden, but also of lowering the amount of overall adjustment. This is why severing the renminbi-dollar link could lead to an upward pressure on the euro.

The upshot is that exchange rate interdependence between China and the euro area is likely to be a lasting feature of the world economy. Although not as tense as the US-China relationship on exchange matters, the potential for further friction between Europe and China is unmistakable.

China's Rise to World Economic Power Status Is Bound to Reduce Europe's Weight in International Organizations

Members of the European Union are already overrepresented in the G-7 and Bretton Woods institutions. At the same, the European Union itself has been able to maintain its share of world output only by enlarging further and further. Against the background of sustained or even impressive growth rates elsewhere, European demographic decline and slow productivity growth are bound to make this overrepresentation unsustainable. The rise of China and other major emerging countries implies giving them adequate representation and responsibility in global governance.

The numbers are well known. According to Goldman Sachs, in 2025 the combined GDP of the BRICs (Brazil, Russia, India, and China) will account for half of the G-7 GDP, and by 2040 it should exceed that. By 2050 the first three economies ranked by GDP should be China, the United States, and India (Wilson and Purushothaman 2003).

Europe's temptation is to embark on postponement tactics, for two reasons. First, it knows its overall institutional weight needs to be scaled down but hopes it can retard the adjustment. Second, as European representation in international organizations is fragmented, scaling it down would most probably imply discussion of burden sharing and the possible merger of representations, which the incumbents tend to retard. This preference for procrastination may coincide with China's strategic interest, which is to avoid freezing the institutional balance of power until its leading role is fully recognized.

But postponement is counterproductive. A multilateral governance system that is still dominated formally (for the G-7 and the international financial institutions) or informally (for the WTO) by the United States and

the European Union clearly does not encourage investment by those who feel underrepresented.[6] Although the G-20 was a step in the right direction, the slow pace of reform of global institutions has acted as an incentive to China (and other emerging powers) to explore alternative bilateral or regional routes.

The reform of the global economic and financial institutions and the rebalancing of power it implies are required not simply for the sake of fairness: More importantly, they are necessary to ensure a sufficient degree of ownership in the multilateral system. Rather than postpone them, the incumbent powers—the European Union and the United States—should instead accelerate the pace of reform so as to create incentives among the emerging powers for a strong commitment to multilateralism.

Such a rebalancing necessarily implies that EU members abandon their current overrepresentation in the G-7 and the Bretton Woods institutions. In turn, this implies some form of pooling of representation in global institutions, especially those where membership is limited. This perspective has been discussed for some time among Europeans, but without much follow-up. External pressures might lead to more serious consideration, because a diminished but still fragmented European representation would have little hope of playing a meaningful role in the governance of the global institutions.

Conclusion

We began by emphasizing the common economic interests of China and the European Union, which have recently become each other's second largest economic partners. We then reviewed potential obstacles to the smooth development of their relations in the future. Although China and the European Union share a strong common interest in the development of their bilateral relations in a multilateral framework, obstacles to such development are bound to arise due to major differences in the two partners' initial conditions and development potentials.

Some of these obstacles are inherently economic, while others are more political in nature. Some can—and must—be addressed by one of the two partners alone, while others need to be discussed and resolved jointly. In several cases, tackling them will involve significant policy adjustments. In view of the importance of China and the European Union, for each other and for the world economy, it is crucial that the two partners engage in more bilateral dialogue that is both forward-looking and candid about potential tensions.

6. This is very clear in the case of monetary and financial cooperation. IMF conditionality at the time of the Asian crisis is commonly regarded as having been distorted by US views and interests.

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