



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 24.10.2006  
COM(2006) 632 final

**COMMISSION WORKING DOCUMENT**

**Accompanying COM(2006) 631 final: Closer Partners, Growing Responsibilities  
A policy paper on EU-China trade and investment:**

**Competition and Partnership**

{COM(2006) 631 final}

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## **Competition and Partnership**

### **A policy for EU-China trade and investment**

#### **Executive summary**

China is the single most important challenge for EU trade policy. EU-China trade has increased dramatically in the past few years, doubling between 2000 and 2005. Europe is China's largest export market; China is Europe's largest source of imports. This trade policy paper addresses the economic and competitive challenges that flow from this change and the responses the EU should adopt in the area of trade and investment. It is part of the broader partnership with China and the approach set out by the Commission in its Communication on relations with China: "*Closer Partners, Growing Responsibilities*".

The EU's open market has been a large contributor to China's export-led growth. The EU has also benefited from the growth of the Chinese market: EU exports to China have more than doubled in the past five years. Competitively priced Chinese products have helped keep inflation and interest rates in Europe lower. European companies have gained from their investments in China. But competition from China has raised serious challenges for Europe in some important manufacturing sectors.

If we strike the right balance, there is ample scope for a continued mutually beneficial trade partnership between Europe and China. Political leaders on both sides should continue to argue for open economic engagement. Europe should continue to offer open and fair access to China's exports and to adjust to the competitive challenge, while pursuing policies to support those bearing the burden of economic adjustment at home. China itself should reciprocate by strengthening its commitment to economic openness and market reform. It should strengthen legal protection for foreign companies and the enforcement of this protection and reject anti-competitive trading practices and policies.

In pursuing this relationship the European Commission will strongly defend openness in European trade with China. But it will also seek to ensure that China meets its WTO obligations and continues to liberalise access to its goods, services, investment and public procurement markets. It will seek the end of forced technology transfers for European investors and imposed export requirements. The EU will seek tougher protection of the legal rights of EU companies, especially in the area of intellectual property and urge China to end the unfair subsidisation or protection of strategic industries. It will seek to ensure that these issues are taken forward within the overall process of dialogue and co-operation between Europe and China and are clearly and comprehensively covered in the new Partnership and Cooperation Agreement including the updating of the 1985 Trade and Co-operation Agreement. To assist European businesses in China, the Commission will oversee the establishment of new commercial resources in China and Europe to support European business and promote language learning.

**1. CHINA'S ECONOMIC REVIVAL**

<i>China's economic return</i>	Two hundred years ago, China was the largest economy in the world. But, by 1978, its share of global GDP had fallen to 0.5%. Since then, China's policy of reform and economic openness has unlocked unprecedented levels of growth and development. Reforms increased the role of the private sector, channelled high levels of savings into investment, increased the level of education, favoured a move away from agriculture into manufacturing and unlocked the potential of China's large pool of 700 million workers. Since 1980 China has enjoyed annual average growth of 9% and has seen its share of world GDP expand tenfold to reach 5% of global GDP.
<i>The benefits of growth</i>	China's growth has resulted in the steepest recorded drop in poverty in world history. Per capita income has doubled; doubled and then doubled again reaching a fifth of current EU level in purchasing power parity. China reduced by 170 million the number of people living on a dollar per day between 1990 and 2000. At the same time, a large middle class with rising purchasing power has emerged.
<i>A new trading power</i>	The progressive integration of China into the international trading system - spurred by its membership of the WTO in 2001 - has provided China with secure, open and predictable export markets. China has become the world's third largest exporter. Its total external trade is now more than three times the combined trade of India and Brazil. Exports represent more than one third of China's economy. However, the majority of China's exports focus on processed goods with limited added value.
<i>A major recipient of foreign investment</i>	China is one of the world's largest recipients of foreign direct investment (FDI) and operates incentives for foreign investment. In 2005, foreign invested companies accounted for more than half of total Chinese exports.

*A stable, growing China is in Europe's interest*

Europe has a critical interest in China's transition to a stable, prosperous and open economy. It recognises that the openness of the EU market to Chinese exports will be a key factor in China's further development. But Europe also stands to benefit from China's growing market for advanced technology, high-value goods and complex services. European consumers will continue to benefit from competitively priced imports from China. The macro-economic benefits of China's export strength for European competitiveness and growth are significant. These gains outweigh the losses suffered in particular areas.

The only sustainable approach for Europe is to welcome China's growth and seek to benefit from it through open trade. To build and maintain political support in Europe for this policy and the adjustment it requires, the benefits of openness and change must be fully realised. This means China must show that it is committed to embracing globalisation as a two way street. China should use its growing influence to champion open markets and fair competition.

*The challenges of sustainable growth*

Moreover, despite its economic success, China faces serious challenges. Its competitiveness as an exporter cannot hide the structural problems it faces. Rapid growth has been accompanied by environmental costs, social inequalities and human health challenges. For growth to continue, China will need to maintain the momentum of domestic reform and rebalance its pattern of growth away from the export sector and towards domestic demand. China should continue its efforts to develop a more sustainable approach to the exploitation of natural resources. In these areas Europe should offer recognition of the challenges and support for reform in China to balance legitimate demands on China's behaviour towards its trading partners and the international system.

## **2. THE EU-CHINA TRADE AND ECONOMIC RELATIONSHIP**

### **2.1. The benefits of openness**

*Mutual benefits*

China's integration into the global trading and investment system has been beneficial for both Europe and for China. The EU represents more than 19% of China's external trade. European companies trading in China have brought capital goods, knowledge and technology that have helped China develop its productive capacity. Reciprocally, trade with China helps to promote growth and jobs in Europe through increasing exports, continuing specialisation in high-value products and services and strengthening the global competitiveness of EU companies.

*EU exports*

EU exports to China increased by more than 100% between 2000 and 2005, much faster than its exports in the rest of the world. In the services sector EU exports to China expanded six fold in the period 1994-2004, based particularly on its strengths in the financial, construction, distribution and educational services sectors.

<i>EU investments in China</i>	Investments in China have allowed EU firms to remain competitive by gaining access to lower-cost inputs. A significant part of the value added of products "made in China" accrues to European companies. It has also helped European business maintain jobs and viable economic activities in the EU such as research, design, marketing, global management and complex manufacturing. Some investments in China have allowed EU firms to gain market share in the China market and supported our exports.
<i>Chinese investments in Europe</i>	China's direct investment abroad remains modest but is increasing rapidly. Total Chinese foreign investment in 2004 was €3 billion with a strong emphasis on securing access to natural resources. Europe only receives a fraction (2%) of this. However, as this investment increases with Chinese commercial expansion beyond its domestic market, European companies will benefit from selling their experience and knowledge in distribution, sales and logistics networks.
<i>The price effect</i>	Competitively priced imports from China have resulted in lower input prices for EU businesses and lower prices for manufactured products in Europe which have generally translated into lower prices for consumers. The total effect on inflation was estimated by the OECD to be -0.2% for the euro zone for the period 2001-2005. This in turn has helped keep low global interest rates. Savings generated as a result of cheaper goods and inputs have been invested in other parts of the European economy.

### **BOX 1: Opportunities for EU businesses to compete in China**

- *The evolution of EU-China trade reflects the evolution in overall EU trade with emerging economies. While the latter, and China in particular, are making significant gains in some segments of high technology products (such as laptop computers, mobile phones and DVD players), the EU is strengthening its specialisation in high-quality products in preference to low- and middle-quality goods.*
- *Commission studies indicate that the expansion of the Chinese market will continue to bring important benefits to EU operators. Although Chinese companies will become competitive in more market segments (for example in basic chemicals or some types of vehicles), other segments will expand rapidly (for example, specialty chemicals, demand for capital-intensive car components) offering new opportunities to EU operators.*
- *The EU is particularly strong in exports of machinery and vehicles which account for two thirds of all EU's goods exports and one third of all Chinese imports of machinery. EU exports to China of chemicals have doubled in the last five years, making China the EU's second export market. The EU market share in China in 2005 was 16% - similar to that in Japan and ASEAN countries but lower than its market share in the USA (20%), India (21%) or in Brazil (31%). There is potential to increase EU market share in line with EU performance in other markets. As China develops, its demand for high-end branded European consumer products will increase.*
- *In order to succeed, EU operators will need to develop a more thorough knowledge of the Chinese market and play on their comparative advantage. Europe's chief assets in its trade relationship with China are innovation, specialisation, quality, related services and brand identity. High unit labour costs are not necessarily an impediment to export success: the strongest performing European exporters to China have some of the highest labour costs in Europe.*

## **2.2. The impact of competition**

*Adjustment in Europe*

Competitively priced imports from China have added to the pressure on the European economy to adjust to new sources of global competition, in particular in traditional low value-added manufacturing. Chinese products compete with EU products not just at home but in emerging markets in Asia, Africa and Latin America. This competition is an inevitable and important spur to European competitiveness. In particular, Europe needs to develop and consolidate areas of comparative advantage in high value and high-tech design and production, foster innovation and help workers adjust and retrain. This makes it all the more urgent to make further progress on the Lisbon reform agenda and to pursue the right competitiveness and adjustment policies at home.

<i>Delocalisation</i>	Delocalisation to China has had a negative impact on certain sectors and regions. This remains, however, a limited phenomenon. Current EU investment in China represents a fraction of total EU foreign investments (only 1% of total EU outflows, excluding indirect investment). The total stock of EU direct investments in China represents 5.5% of overall foreign investment in China.
<i>The technological challenge</i>	China's research efforts are developing rapidly and China has the potential to move up the value chain into traditional areas of EU expertise. However, China has yet to develop a coherent policy on innovation, and is hampered in its efforts by its inadequate protection of intellectual property. While China has become the world's first exporter of information technology products, a large proportion of these exports come from foreign companies established in China that import research-intensive, high value-added components. Europe cannot, however, afford to be complacent.
<i>The trade deficit</i>	Europe runs a steep trade deficit with China: in 2005, Chinese exports to the EU reached €158 billion and EU exports to China €52 billion, resulting in a trade deficit of €106 billion. However, approaching the EU-China trade deficit in isolation is misleading. Asia's share of EU imports has remained relatively stable at 20-25% over the last decade. The trade deficit with China hides to some extent the fact that its exports have partly replaced exports from other Asian countries.
	While the Chinese competitive challenge needs to be put clearly in perspective, it is unquestionably real and has important consequences for companies and individual workers in Europe. This is why securing reciprocal free and fair market in access in China is crucial. Here, a range of obstacles to market access and skewed conditions of competition need urgent attention.

### 2.3. Obstacles to market access

<i>Tariffs</i>	While Chinese tariffs have gone down significantly as a result of China's WTO accession, EU exports still face a number of tariff and non-tariff barriers to trade and restrictions on investment in manufacturing and in services. There is a growing perception that incomplete implementation of WTO obligations and barriers to market access are preventing a genuinely reciprocal trading relationship between Europe and China.  In the course of WTO accession China's tariffs were reduced to an average of 8.8% for non-agricultural products. However, China has maintained a number of tariff peaks in some industries of particular importance for the EU such as textiles and clothing, leather and fur, footwear, ceramics, steel and vehicles.
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<i>Non-tariff barriers</i>	European exporters and investors are facing an increasing number of unjustifiable non-tariff barriers in the form of product certification, labelling standards, import approval requirements and customs clearance delays. The application of laws is often not uniform and regional variations in customs procedures have a negative impact on trade. Unreasonable sanitary and health requirements can create barriers that hamper exports to China, in particular for agricultural products. Chinese national standards often differ significantly from international standards. This results in high compliance costs and extended delays for business which impact on their ability to sell on the China market, affecting in particular EU small and medium-sized enterprises.
<i>Government procurement</i>	China committed itself to opening its procurement market and acceding to the multilateral Government Procurement Agreement as soon as possible after its accession to the WTO. China has now committed to start accession negotiations in 2008. However, many procurement markets remain closed to European businesses. In some sectors, technology transfers have been made a condition for foreign companies to participate in international bids.
<i>New policies discriminating foreign operators</i>	In key sectors such as automobiles, steel, semiconductors or shipbuilding, new policies are emerging which appear to be based on a ‘China first approach’ contrary to the non-discriminatory principles of the WTO. In a number of industries China has been imposing local content requirements, either through direct legislation or investment authorisation, limiting EU exports and unfairly aiding local industry. There is a growing risk that competition policy will be used against foreign operators and that the lack of independence or transparency of many regulators results in decisions favouring Chinese operators.
<i>Investment restrictions</i>	In the manufacturing and services sectors European investors are still prevented from setting up wholly owned foreign enterprises and are required to establish joint ventures with Chinese partners. In the telecoms and financial services sector, EU firms have been unable to expand significantly because of high capital requirements and complex approval procedures. In the manufacturing sector, China continues to maintain investment restrictions on some key industries for Europe such as automobiles, petrochemicals or steel.

#### **2.4. Conditions of competition**

EU companies often find themselves competing on unfair terms in China. The absence of conditions of fair market competition and inadequate legal protection pose serious problems. China’s policies on the environment, social standards, currency valuation and natural resources can distort trade.

<i>Intellectual property and legal rights, forced technology transfers.</i>	The adequate protection of intellectual property rights such as patents, copyrights and trademarks is central to the exercise of Europe's comparative advantage in innovation, design and high-value production. Insufficient protection of intellectual property represents a pressing challenge for EU businesses in China. China is by far the largest source of counterfeit and pirated products seized at the EU's borders. While China has made welcome progress in setting up an intellectual property regime, loopholes remain and effective implementation and enforcement of laws remains uneven or lacking. EU companies also face an opaque and burdensome legal and judicial system that offers insufficient guarantees of legal protection of the rights of EU companies.
<i>Subsidies</i>	China has channelled significant subsidies to favoured national industries, in particular companies destined to become national or regional champions. These companies have also benefited from preferential policies such as privileged access to the banking sector. In some cases, such as the automotive and steel sectors, whole sectors benefit from an integrated industrial policy intended to support domestic production and boost exports. China has also developed a taxation system granting tax preferences contingent on the use of local content or export performance.
<i>Flexible Exchange Rate</i>	China's exports to the EU have also benefited from the currency alignment of the Chinese renminbi to the dollar, which has given them an important competitive advantage. China is now moving towards increased flexibility in its currency regime, which should help shift the balance to higher levels of domestic consumption.
<i>Excessive saving depresses demand for imports</i>	Demand for EU products in China is also suppressed by low domestic demand resulting from high savings as a result of limited public provision of health and social security services. Enterprises' savings are also very large and account for about half of China's savings. This both suppresses domestic demand, including for EU goods and services and ensures that the bulk of domestic production is exported.
<i>Environment, social and safety conditions</i>	China's regulatory regime for the protection of the environment remains incomplete and implementation on the ground inadequate or discriminatory in favour of local producers. This is contributing to the rapid deterioration of China's environment. China has also maintained restrictions on investment or imports of certain environmentally friendly products and services. China has yet to ratify, transpose and implement into domestic legislation four of the eight core ILO conventions relating to freedom of association, collective bargaining and forced labour and other important conventions on labour inspection, health and safety at work and social protection. Chinese companies also often fail to meet reasonable safety standards for their products; half of the alerts in Europe for dangerous non-food products are for products manufactured in China. The lower environmental, social and safety standards applied in China confer a competitive advantage to production in China.

*Distorting the market for global trade in natural resources*

China's race for natural resources abroad has become a major phenomenon. China is now the second biggest fuel importer globally: this is a clear indication that global competition for resources is set to increase. China's export performance also relies on imports of resources from many developing countries. In some cases, China is subsidising the import of raw materials conferring advantages to its industry. At the same time, China limits exports of certain domestically abundant natural resources such as coal, coke, rare earth, hides and silk, which can distort availability and price of raw materials in world markets.

### **3. THE EU'S RESPONSE AND PRIORITIES FOR ACTION**

#### **3.1. Insisting on openness**

*Enforcing China's WTO obligations*

Europe should pursue a fair and robust trade policy on China. It should insist that openness benefits both Europe and China, and that an economically strong China is in Europe's interests. It cannot call for openness from China from behind walls of its own.

*Liberalising beyond WTO obligations*

The EU continues to monitor closely China's implementation of its WTO accession obligations. Substantial work remains to be done by China. This will remain a central priority for the EU in the years to come. The non-accession to the WTO Government Procurement Agreement leaves important Chinese markets closed and China should honour its commitment to open accession negotiations in 2008 and to work to bring these to a rapid conclusion. In 2007, the Commission will undertake a comprehensive review of market openness in China and China's implementation of its WTO commitments. It will strengthen its links with EU business to help identify key areas of concern.

The EU will continue to urge China to move beyond its WTO commitments in improving market access for EU companies. The EU market is one of the most open markets in the world and will continue to pursue further opening of the Chinese market to create reciprocal opportunities for EU and Chinese operators. The EU will work with Chinese authorities at all levels to achieve this goal. In 2007 the EU will also reshape its overall market access strategy. It will increase cooperation with Member States to improve EU exports to China.

#### **3.2. Levelling the playing field**

The EU will continue to press China to improve its record in protecting the rights of EU companies through a transparent legal and judicial system where the regulators are fully independent.

<i>Combating forced technology transfers, piracy and counterfeiting</i>	Following a global enforcement survey this year, China is now the EU's first priority for intellectual property enforcement worldwide. China should implement its WTO commitments both in law and on the ground and impose effective deterrents against counterfeiting and piracy. The EU will create a set of concrete benchmarks against which to measure China's progress. The EU will work with China on the creation of a special risk assessment system for customs controls to fight counterfeiting more effectively and set up contacts between EU and Chinese ports and airports. The EU will address as a priority requirements for technology transfer that are not based on voluntary business decisions and the non-payment of royalties to EU right-holders. The EU will launch a substantial programme in China to improve IPR implementation and to curb the production and trade in China of counterfeit and pirated goods and their export to Europe. The EU will cooperate more closely with key international partners in joint efforts in this field.
<i>Subsidies, banking reform and trade restrictions on raw materials and energy goods</i>	The Commission will press China for improved transparency in its subsidy regimes and will insist that China abide by its WTO commitment to end the granting of prohibited subsidies. The Chinese banking system should be reformed to work on a commercial basis, and soft loans and other forms of unviable lending should be discontinued. The Commission will urge China to allow market forces to operate in its trade in raw materials and energy goods such as coal, coke and rare earths.

### 3.3. Supporting European companies

	The Commission will take action to assist EU companies on the ground, in particular small and medium-sized enterprises. In doing so, the Commission should complement rather than duplicate initiatives taken by Member States or private operators.
<i>Protecting European IPR</i>	Working through existing structures, such as the IPR helpdesk and the network of European Information Centres, the EU will extend and strengthen the existing intellectual property rights helpdesk to provide training and advice on protecting and defending European intellectual property rights in China. The EU will also work to develop private-public partnerships with EU industry federations and others to improve the protection of IPR in China.
<i>Supporting EU businesses in China</i>	The Commission will seek partners to establish a European Centre in Beijing to provide support for companies wishing to start exporting or investing in China. Preparatory work should start in 2006 to analyse the feasibility and possible structures for such support.
<i>Language training</i>	In July 2006 the Commission launched the EU-China Executive Managers Exchange and Training Programme which will provide the opportunity for 200 European managers to learn Chinese in the next five years. The Commission will press for this programme to be extended beyond 2010.

<i>Strengthening the Commission on the ground</i>	The Commission will further strengthen the focus on trade activity of the Commission Delegation in Beijing. It will seek to reinforce its activity in Shanghai and Guangzhou in order to be closer to Chinese authorities and EU business in key commercial centres.
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### 3.4. Defending the EU's interests: dialogue first

<i>WTO dispute settlement</i>	Where trade irritants arise between China and the EU, the EU will always seek to resolve them through dialogue and negotiation. However, where this fails, the Commission will use the WTO dispute settlement system to resolve trade issues with China and to ensure compliance with multilaterally agreed rules and obligations. This is not a question of replacing cooperation with confrontation but of creating a sound relationship based on objective application of agreed multilateral rules.
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<i>Using anti-dumping and anti-subsidy instruments</i>	Trade defence measures will remain an instrument to ensure fair conditions of trade between China and the EU, as with other countries. The EU will use these instruments carefully but rigorously where they are justified. At present, the conditions for granting Market Economy Status (MES) to China for anti-dumping investigations are not fulfilled. The EU is actively working with China with a view to creating the conditions permitting an early granting of MES. Recent progress has been made on some of the conditions. The Commission will continue to work with the Chinese authorities through the mechanisms we have established and will be ready to act quickly once all the conditions are met. An improving bilateral trade relationship should help create the environment in which this happens. China's policy of reform will be instrumental in fulfilling the technical criteria for granting MES.
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#### ***BOX 2: The role of dialogue***

In recent years the European Commission has established a number of important economic dialogues with China that have trade implications. The Commission, the European Parliament and the Economic and Social Committee have been at the forefront of this activity.

These dialogues cover issues such as intellectual property, market access, macroeconomic and financial sector issues, agriculture, competition, regulatory and industrial policy, and general product and food safety. The EU has also concluded sectoral agreements with China such as the Customs Cooperation Agreement which provides for reinforced EU China cooperation on IPR controls and supply chain security.

These dialogues help promote regulatory cooperation and convergence and are important in managing an increasingly complex relationship. They can also play a crucial role in preventing difficulties before they become trade disputes. The Commission will maintain the focus on trade and economic issues. Some areas where further dialogue is important include: decent work, sustainable trade, China's policy on raw materials and energy, illegal logging, China's need to improve environmental protection and statistics.

When it is useful and appropriate, EU and Chinese business, trade unions, NGOs and other stakeholders should be involved in technical and high-level meetings. European companies should play an active role in implementing the decent work agenda and improving social and

environmental standards by adopting European norms, eco-technologies and standards of corporate social responsibility in their operations in China.

The cooperation programmes which support these dialogues should be continued. The EU China Trade Programme which supports capacity building in China on trade policy issues with €15 million for the period 2004-2009 should be renewed after 2009. Its scope should be extended beyond the Central Government to include local and regional government.

### 3.5. Building a stronger global relationship

	<p>The EU's partnership with China should be used to draw the two economies closer together and to engage China on global issues.</p>
<p><i>Concluding a new EU-China bilateral agreement</i></p>	<p>At the heart of that partnership will be the new Partnership and Cooperation Agreement (PCA) with China. This Agreement will include a specific focus on trade and investment issues. A key objective of the PCA will be building on China's WTO commitments to remove restrictions on investment and foreign ownership in China, obtain better protection of intellectual property and negotiate mutual recognition of geographical indications. The EU will also seek to address with greater intensity sustainability and environmental aspects and impacts of its economic and trade relations with China and enhance cooperation on safety and health standards.</p>
<p><i>Increasing China's engagement with the multilateral system</i></p>	<p>China is already a major beneficiary of the international trading system and would stand to gain even more from a successful conclusion of the negotiations under the WTO Doha Development Agenda, particularly in the area of trade in industrial goods. But for the negotiations to succeed, greater leadership from China is necessary. The EU calls on China to assume a responsibility commensurate with the benefits it derives from the multilateral trading system and to make a substantial contribution to reviving and completing the WTO Doha round. China should take the lead in offering better access to its own markets, including for key developing country imports like textiles and manufacturing inputs. The EU and China should strengthen their cooperation in the WTO and in other multilateral rule-making organisations.</p>
<p><i>Addressing macro-economic challenges</i></p>	<p>A major issue for the stability of the world economy is to ensure an orderly correction of the large current account imbalances of the major economic zones. The US current account deficit reached the unprecedented level of 6.4% of GDP in 2005, while current account surpluses have continued to widen in the Middle-East oil-exporting countries and in Asia. China's current account surplus reached 7.2% of GDP in 2005. The EU, drawing on our own experience, will, in the appropriate fora, continue to encourage China to implement fiscal, monetary and structural policies that would rebalance its growth pattern and ensure long-term sustainable growth.</p>

## Conclusion

China's re-emergence will continue to have a major impact on every part of the global economy. It will be felt in people's daily lives, from the cost of petrol to the price we pay for our clothes. It entails major challenges for global sustainable development. Adjusting to the competitive challenge and driving a fair bargain with China will be a central political and economic challenge of EU trade policy in the decade to come. Europe and China will be increasingly compelled to cooperate on global issues as responsible trade and economic global leaders.

China's WTO accession in 2001 has provided it with extensive and stable access to foreign markets, notably in Europe. However, European companies, while gaining from China's growth, continue to face serious barriers to access China's market. There is a growing risk that the EU-China trading relationship will not be seen as genuinely reciprocal. Political pressure in the EU to resist further openness to Chinese competition is likely to increase if these problems are not addressed, as we are already seeing in the United States.

European trade policy towards China will seek to promote openness and cooperation to mutual benefit, taking into account the significant domestic challenges China faces. Europe seeks reciprocity from China in a trade partnership of equals. It should be accompanied by strong policies to assist those bearing the burden of economic adjustment in Europe. Europe should accept fierce competition. China should ensure that it is fair competition.