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China Research Insights

EU-China merchandise trade: The huge deficit as a cause for concern

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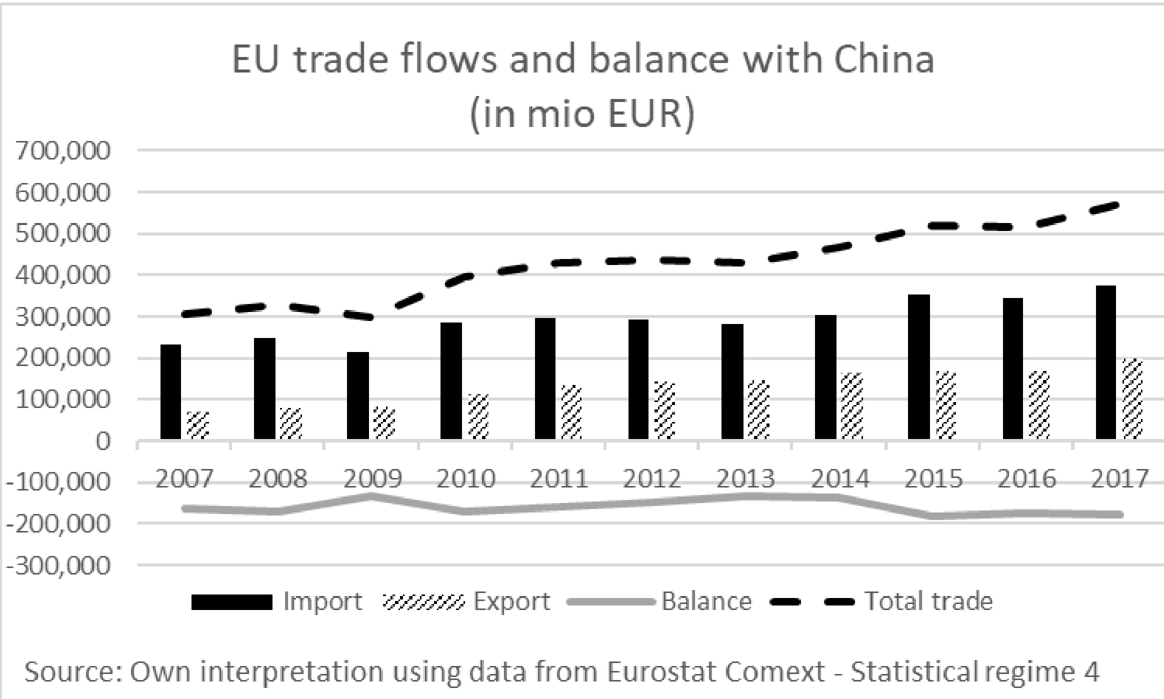
Connecting West and East for centuries, the importance and volume of trade between the EU and China has changed significantly in recent years. China is now the EU's second biggest trading partner behind the USA[1], the biggest source of EU's imports, its second biggest export market and the fastest growing market for European exports too.[2] EU and China trade on average about EUR 1.5 billion a day.

About 40 years ago, EU-China trade was not significant for neither of them. The new era for their trade started after China's opening to the world with the great liberal reform in 1978. In the 30 years of isolation before, China had closed the door for trade to the old European partners, except for some of the socialist brother countries, such as Yugoslavia and Albania. Now the main aim of China's new export policy was to earn foreign currency in order to buy technology to develop the domestic economy. In 1978, the EEC[3] signed its first trade agreement with China, which was changed in 1985 into the Trade and Economic Cooperation Agreement – this is still the main legal act governing their commercial relations. Economic sanctions that EEC imposed on China after the Tiananmen Square[4] massacre in 1989 led to a halving in trade volume.[5] However, for many member states of the EEC the Chinese market was too important and soon they returned to normal trade relations. Since that time, their trade has been gradually improving. The major change happened when China joined WTO in 2001 and opened its economy to the rest of the world. Since 2004, the EU has been the most important trade partner for China. Today, the EU-China trade relations are in the most developed stage ever, forming the second-largest economic cooperation in the world.

The value of their mutual merchandise trade in 2017 almost doubled compared to ten years before, but with EU's continuous merchandise trade deficit. While the value of the

EU's imports from China was close to EUR 375 billion, the value of exports was only EUR 198 billion, counting for the total value of the trade of over EUR 573 billion.[6] Thus, the EU currently runs a substantial trade deficit of EUR 176 billion with China, continuing a trend of structural deficits in the trade balance.[7] Surprisingly, the biggest importer in the EU is the Netherlands (83 bn.) ahead of Germany (72 bn.) and U.K. (53 bn.).[8] In relative terms, as share of total extra-EU imports, the Czech Republic shows the highest share (33.9% of Czech extra-EU imports are from China) followed by the Netherlands (30.4%).[9] The Netherlands' strong role as a distribution hub from which Chinese goods are re-exported to all of Europe explains the outstanding position of the Netherlands in the import statistics.

Manufactured goods dominate EU-China trade. "Machinery and transport equipment" is for both parties with just over half of their exports the largest product category in bilateral trade. Adding up other categories of manufactured goods and chemicals, the total value of manufactured goods reaches 96.6% of the EU imports and 83% of its exports.[10] EU's main imports from China are telecommunications equipment, automatic data processing machines, electrical machinery, footwear and clothing.[11] EU main exports to China are motor cars and vehicles, automotive parts, aircraft and pharmaceuticals.[12] A closer look at the trade in manufactured goods shows that the product composition within the category differs: China exports lower to middle-value adding products to the EU, mirroring its comparative advantage in low-cost assembling and process manufacturing; whereas the EU exports rather goods with high value-added through engineering, branding and innovation.



A bright spot is Europe’s surplus in the trade of services. So far, EU-China trade in services amounts to no more than 10% of total trade in goods.[13] However, EU's exports of services make up 19% of EU's total exports of goods, while China’s service share in exports is just 8%.[14] The EU’s surplus in trade with services with China in 2016 was EUR 8.8 billion, putting China on the list of the EU’s largest surplus partners, after Switzerland, Russia, Japan and Norway.[15] As the EU services exports grow with around 12% faster than the merchandise trade (7.6%), the service sector will gain in importance in the economic interaction with China.

The EU’s enormous trade deficit of EUR 176 billion remains a major point for discussion. A trade deficit is the result of many influences and reflects comparative (dis)advantages of the involved parties. Several developments will shape its future size. First, the trade in goods deficit just reflects the current structures in global trade and China’s position as the “factory of the world”. China plays a major role in the global value chains of many industries, particularly in the electronics sector. A value-added analysis of trade flows reveals that the deficit in EU-China trade is substantially lower when trade flows are counted on a value added and not on a gross trade basis.[16] The specialization of Chinese firms in labor-intensive process manufacturing and assembling leads via lower labor costs to comparable low domestic values added. However, China’s shift from “made in China” to “designed in China” will further increase the input from medium- and high-skilled labor and accordingly domestic value added of its exports.

Second, the Brexit will reduce EU’s trade deficit by around EUR 35 billion (in 2017 terms) and, unfortunately, the relative importance of the EU in the trade relations too.[17] Third, increasing standards of living, the emergence of a large middle-class and the re-orientation from an export- to a domestic consumption-driven model will stimulate imports of higher priced products from the EU. Chinese consumer appreciate European fashion products, cars, food and beverages.

Broadening the view beyond merchandise trade, the trade in services will benefit from this economic catching-up too. An opening of the financial and services sector for European foreign direct investment would support the growth of services exports from the EU too. Regarding tourism, the Chinese share of EU-28 exports of travel services[18] almost doubled between 2010 and 2015, reaching nearly 7% and 4th place in the ranking behind USA, Norway and Switzerland in 2015.[19] Finally, the effects of the Belt-and-Road Initiative (BRI), the Chinese project to create improved logistic and economic corridors in Eurasia, and the further growth of international e-commerce on the foreign trade balance are hard to estimate. Today, the BRI works rather in a one-way direction, fueling far more Chinese exports to Europe than attracting imports from there. The expansion of Chinese internet-related service firms and e-commerce firms such as Tencent, Alibaba or JD.com to Europe establishes new sales channels for Chinese exports what will rather widen the trade gap than close it.

Such a huge and lasting trade deficit is a cause for concern. But there exists no simple solution for shrinking the trade deficit. Merchandise trade is the most developed area in the EU-China relationship. The two economic powers have integrated so much that it is impossible to imagine their economic future without each other. As the trade deficit is mainly the result of comparative advantages, exchange rate constellations, trade barriers and demand patterns, solutions have to consider the underlying developments and structures in the economic relations between the EU economies and China in a global trade context.

Notes

1 *http://ec.europa.eu/trade/policy/countries-and-regions/countries/china/*

2 *Ibid*

3 European Economic Community, "an economic association of western European countries set up by the Treaty of Rome (1957). The original members were France, West Germany, Italy, Belgium, the Netherlands, and Luxembourg. (*http://www.oxforddictionaries.com*)

4 Such as suspending high-level contacts, postponing new economic cooperation projects, banning army sales and military cooperation, lifting ban on the official credit financing for China (source: Financial Times, 28 June1989 and Wall Street Journal, 20 December 1989, taken from Peterson Institute for International Economics, www.piie.com)

5 Comparing the results from www.wto.org

6 *http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113366.pdf*

7 Hong Kong is not included in this figure: It is with EUR 48 bn. the 17th largest trade partner of the EU and many Chinese firms conduct their foreign trade via HK.
http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_122530.04.2018.pdf

8 *http://ec.europa.eu/eurostat/statistics-explained/index.php?title=China-EU_-_international_trade_in_goods_statistics#EU_deficit_with_China_remains_substantial*

9 *Ibid*

10 *http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113366.pdf*

11 *http://ec.europa.eu/eurostat/statistics-explained/index.php?title=China-EU_-_international_trade_in_goods_statistics#EU_deficit_with_China_remains_substantial*

12 *http://ec.europa.eu/trade/policy/countries-and-regions/countries/china/*

13 http://ec.europa.eu/eurostat/statistics-explained/index.php/International_trade_in_services

14 *Ibid*

15 *Ibid*

16 García-Herrero, A., Kwok, K.C., Xiangdong, L., Summers T. and Yansheng, Z. 2017. EU-China Economic Relations to 2025 – Building a Common Future, The Royal Institute of International Affairs.

17 http://ec.europa.eu/eurostat/statistics-explained/index.php/China-EU_-_international_trade_in_goods_statistics

18 EU service exports refer to the expenditures of Chinese tourists traveling in the EU.

19 *http://ec.europa.eu/eurostat/statistics-explained/index.php/International_trade_in_services_by_type_of_service*

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