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PGIM FIXED INCOME

THE MYRIAD IMPLICATIONS OF THE EU-CHINA TRADE DEAL

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On the surface, the recently agreed upon trade agreement between the EU and China—the Comprehensive Agreement on Investment (CAI)—pertains to investment matters. It improves the access for European companies in key markets, somewhat levels the playing field for EU investors in China, and commits the country to sustainable development policies, including adherence to international labor standards. However, the deeper implication is that the deal also derails U.S. efforts to build a united front with Europe against Chinese economic practices. In this context, it represents a significant geopolitical win for Beijing. While the conclusion of CAI suggests the worst of the trade tensions between the West and China trade are over, the relations between the U.S. and EU will likely be more tense than initially thought after the U.S. elections. Any strategy to counter China by the U.S. and the EU will likely now be less disruptive due to Europe's—and Germany's—fears of confronting China.

After nearly seven years of negotiations, the deal's prospects seemed rather bleak as of late September 2020. But following the U.S. elections in November, China's President Xi became increasingly involved and offered the EU the necessary tactical concessions to see the deal through. The CAI was agreed upon in principle on December 30, 2020 and is expected to become effective in the first half of 2022 (which coincides with France holding the EU's rotating presidency) and requires ratification by national governments, including the European Parliament.

China's concessions included substantive commitments on three key pillars: market access, a level playing field, and sustainable development. The deal is designed to improve European investors' access to key Chinese markets, including the financial services, new energy vehicle, cloud services, and healthcare sectors.

The deal confirms what many analysts have always known: Germany is Europe's weakest spot when it comes to China and Russia.

Whereas for China, the deal broadens its access to some manufacturing sectors and the bloc's energy industry, bolstering China's relatively strong existing access to the European market. European Commission officials have also said that, under the agreement, China pledged to "solid provisions on sustainable development, including in relation to environment and climate…as well as corporate social responsibility and labor." Finally, the deal, at least formally, commits Beijing to set rules against forced technology transfers and improves the transparency regarding firm subsidies, including the submission of a yearly list of some subsidized sectors, excluding those deemed critical to Chinese national security interests or as emerging technology sectors.

While the CAI may sound constructive on paper, there is skepticism about China's willingness to live up to its commitments made under the deal. Concerns mainly relate to China's track-record of circumventing its international commitments on trade and investments, and more recently, Beijing's violation of the Sino-British Joint Declaration on Hong Kong and the Sino-Australia free trade agreement. In addition, the deal apparently lacks a credible enforcement mechanism in cases where China breaks CAI provisions, including investor protection mechanisms to litigate individual disputes. Thus, it remains to be seen whether China's key pledges can be enforced, and that uncertainty presents a serious risk to the deal's long-term success.

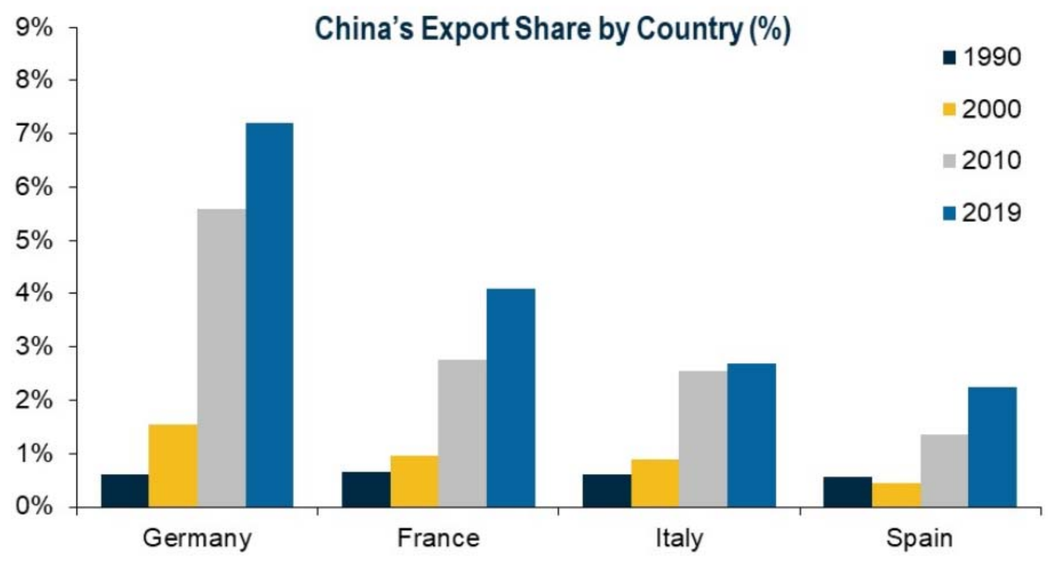
For its part, the CAI is a significant diplomatic and strategic achievement for Beijing. The deal tightens the economic tether to the EU, alienates some member states (Spain, Poland, Belgium, and Italy), maintains Germany and France as the bloc's strongest economies and Europe's main political engines, and deliberately tries to pre-empt the formation of a coordinated front between the U.S. and Europe to counter China.

As such, the deal complicates the Biden Administration's policy towards China and undermines its effort to build a coalition of like-minded nations to address China's economic and authoritarian policies. Getting the EU on board with this effort has been a top priority for the incoming administration. And it seemed things were headed in the right direction when both the EC and the EU Council published strategy papers ahead of the mid-December summit offering to work with the U.S. on "mapping out" a common strategy to boost trans-Atlantic cooperation and bridge the political chasm that has developed between the U.S. and EU in recent years.

Against this diplomatic backdrop, China intensified its efforts to close the deal with Europe. President Xi found a willing negotiator in German Chancellor Merkel; she was also able to get France on board, reportedly promising French President Macron that the deal would be ratified under his EU presidency in the first half of 2022, which coincides with the French presidential election. Merkel's push aligned with Macron's stated goal of advancing Europe's "strategic autonomy" concept, and the CAI presented a propitious opportunity.

The deal comes with political costs for the EU and Germany. First, the EU's relations with the incoming Biden Administration will be more tense than initially thought. Biden's senior officials were swift to express their disapproval of and surprise at the deal. A return to a "normal" relationship between the U.S. and Europe will now face higher hurdles. Mutual trust may have suffered as a result. Second, the deal confirms what many analysts have always known: Germany is Europe's weakest spot when it comes to China and Russia. Without Germany changing its mercantilist approach to foreign policy, it will be hard to create a credible joint front against Chinese economic practices. Germany is unlikely to join any counter-China initiative that endangers its exports (see the Figure below), especially in the auto sector.

FIGURE : GERMANY LEADS EUROPE'S GROWING SHARE OF EXPORTS TO CHINA



Source: MF, Morgan Stanley Research

Fearing the economic consequences of antagonizing China, Germany will push for a much softer approach, suggesting that the worst of the trade tensions between China and the West are in the past. Finally, the CAI will likely undermine the EU's soft power narrative considering it implicitly treated the forced labor issue as a secondary concern relative to investment. When combined with the EU's past silence on issues related to China's authoritarian policies and human rights violations, the CAI will sharpen the focus on U.S.-EU disagreements in the months ahead.

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