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The Third Type of Inter-System Competition: Europe and the Rise of China*

In the debate over the economic and political future of Europe a widely debate challenge is that the global balance of power is shifting towards Asia, and especially towards China.

In the "old West" it is usually taken for granted that the combination of a market economy, a liberal democracy and the rule of law is economically more successful and more humane than any other form of social order. This certainty has been shattered by the rise of China, which is achieving dynamic economic development with a political system where a single political party rules and key components of liberal democracy like press freedom, the separation of powers and the protection of the individual's rights are either entirely absent or lack substance. Although aspects of the market economy like private entrepreneurship and free pricing are playing a growing role in China, the state nevertheless controls economic developments in many sectors and owns almost all of the banking system, as well as most large industrial companies. In the Fortune 500 ranking of the biggest companies worldwide, 103 companies come from China, including 73 companies in which the Chinese government holds a majority share. There is also little transparency as to the extent of state influence in companies that are officially private.

In other words, the "old West" is now facing a third kind of inter-system competition. The first type of such competition to emerge was the conflict between market economy-based democracies and centrally-managed communist states. This was a question of military dominance and the expansion of the opposing economic systems, especially to the third world. It ended with the demise of communism in Russia and Eastern Europe. The second form of inter-system competition takes place between market economies seeking to be the best business location. In this scenario states compete via their taxation rules, regulations, education and social welfare systems in order to attract investment and jobs to their country. This form of competition is ongoing. The third type of inter-system competition involves Western democracies competing with authoritarian forms of state capitalism that can be found in China, but also, in slightly different forms, in Russia and other smaller states like Vietnam. This type of inter-system competition involves economic competition and military supremacy. Will Chinese state capitalism outperform market economies in science, technology and ultimately in terms of economic dynamism and efficiency? Will China's role in developing and emerging economies, especially in Africa, grow and reduce the influence of the West? Will this happen to the extent that the global economic and trade order will be increasingly geared towards China's interests? This raises the more fundamental question of whether there is a future for Western values like the freedom of private individuals, the rule of law and freedom of speech?

What are the specific challenges facing Europe as a result of this new kind of inter-system competition? The rise of China initially made itself felt via imports of cheap consumer goods like textiles. The flood of cheap products from China put many companies in Europe under high competitive pressure, forcing them to close down or to restructure. This led to job losses and falling wages, especially for low-skilled workers. The individuals affected were hit hard and many see the anger of these "losers" of globalization as a driver of political polarisation. However, at the same time, China's entry into the world economy did Europe a lot of good, and not only because consumers benefitted massively from cheap imports. Many companies, in particular many German companies producing investment goods or cars, found new sales markets in China. This protected existing jobs in Europe or led to the creation of new ones.

In recent years Chinese companies have become increasingly active as international investors. Chinese foreign direct investment accounted for 2.8 percent of its gross domestic product in 2005. By 2017 this figure had risen to 12.8 percent. Although the volume of foreign direct investment in China is larger, it is growing far more slowly. In 2005 it totalled 20.6 percent of China's economic output and in 2017 it amounted to 24.3 percent.

China's growing business interests abroad are arousing widespread suspicion. There are, however, at least five good reasons for it to engage in foreign investment. Firstly, China invested its foreign trade surpluses in US government bonds for years. This created a dangerous dependence on the US dollar for China. The USA could devalue these debts by simply printing more money.

It has repeatedly been argued that the dependence works in the opposite direction, namely that China could threaten to sell its US government bonds and push up interest rates as a result. This argument overlooks that fact that other investors would step in if interest rates were to rise; and that, at least temporarily, the US Fed could buy unlimited volumes of bonds if it wished to curb any interest rate rise. So, all in all, it makes sense for China to broaden its foreign investments.

Secondly, a growing number of Chinese private investors are trying to accumulate assets abroad to protect them from potential seizure by China's government. Thirdly, Chinese companies are trying to improve the distribution channels for their products via foreign investment. Fourthly, China is also trying to protect its access to commodities. Fifthly, Chinese investors are buying technology companies to acquire know how. With its "Made in China 2025" strategy, the Chinese government has set itself the goal of becoming a global leader in ten key industries ranging from electro-mobility to bio-medicine. In addition to its own research, buying in technologies plays a key role in this strategy.

In principle, these reasons closely resemble the incentives driving European and US investors. A major difference, however, is that when China makes investments it is harder to recognise whether a private investor is behind the deal, or whether the Chinese government is pulling the strings. That the Chinese government exercises a great deal of influence is primarily clear from its infrastructure investment abroad. With its "New Silk Road" initiative China wants to revolutionise economic exchanges between Asia and Europe by expanding road networks, rail links, ports, communication and energy networks with Chinese money. This strategy can be expected to give China a growing political influence. One

manifestation of it is the purchase of the port of Piraeus in Athens, Greece's largest sea port, by Chinese investors.

Should Europe worry about these developments? In principle it can be argued that Chinese infrastructure investments are welcome, as they stimulate the economy. Although they may increase China's influence in Europe on the one hand, they will also make China more heavily dependent on Europe on the other. If the Greek government believes that the port of Piraeus is not being operated as it should be, it could expropriate Chinese investors or neutralise them in other ways. From a European point of view, however, the risk lies less in control over critical infrastructure than in China being able to buy control over EU policy by financially supporting individual EU member states. Many EU decisions call for unanimity among its members. That makes the EU particularly susceptible to attempts to divide it by outsiders. NATO's former Secretary General Anders Fogh Rasmussen recently criticised several EU states that have received Chinese investment of watering down an EU declaration made in summer 2017 that decried Peking's claims to maritime rights and resources in the South China Sea as a violation of international law.

The situation with the takeover of technology firms by Chinese investors is even more complicated. A much-discussed example is the takeover of the robotics company Kuka. In principle, companies that own valuable patents or have a technological advantage over their competitors can be expected to be correspondingly expensive. If Chinese companies, backed by the government, outbid interested parties from other countries, it follows that they may end up paying more for the firm in question than it is actually worth. Europe may stand to benefit from this. However, it could also be naïve to make this assumption for two reasons. Firstly, it could be risky for a European or US company active in the Chinese market to compete against a Chinese bidder in a takeover. The Chinese government could react and block the company's market access in China. Secondly, research and development activities have externalities, that is economic implications which are not taken into account in market transactions. If know-how migrates to China via a takeover, the costs for Europe may be higher than reflected in the purchasing price.

However, the challenges of this new third kind of inter-jurisdictional competition go far beyond the implications of trade and capital flows. Ultimately, it is a question of whether Chinese state capitalism can generate more economic prosperity than western market economies. In the end, this will also define military power relations. If differences in purchasing power are taken into consideration, China's gross domestic product is already higher than that of the USA and the EU. Its per capita income is just a third that of the EU's, but China is catching up fast: in 2005 its per capita GDP was only a sixth of the EU's.

But China's high growth rates do not belie the fact that the population is paying a very high price for them; and that its economy faces major challenges. Investments in China currently account for 44 percent of gross domestic product. These funds are lacking when it comes to providing consumer goods and services for China's population. In most emerging countries at a similar level of development, the investment ratio is closer to 30 percent. A significant share of investments in China is inefficient. The International Monetary Fund (IMF) estimates that a quarter of funds flows into poor investments. A large share of these poor investments are made in state-owned companies, which only manage to stay above

water thanks to cheap loans from state-owned banks. This is not only due to poor decisions made by these companies. China's government also uses state-owned companies to respond to socio-political problems. If private companies withdraw from regions and sectors that are in economic decline, state-owned companies often increase their share in them. This is designed to prevent unemployment from turning into political unrest.

Nobody knows whether an economic system with state-controlled investment decisions in which publically-owned companies perform social and regional policy tasks may prove more successful than the approach that prevails in Europe of a strict division between the public and private sectors.

But one thing is clear: to stand a chance of holding their ground against this new type of inter-system competition, European states need to do their homework. They need to ensure that Europe offers an attractive prospect for both talented youngsters and investors from around the world. As far as economic exchanges with China are concerned, the opportunities and risks at stake need to be weighed up carefully.

Three points are crucial: firstly, the EU cannot allow China or other players to cause rifts in the EU in order to manipulate political decisions. This not only applies to foreign and security policy, but also to economic policy. Just like China and the USA, the EU has to be in a position to use access to Europe's single market as a tool to exert pressure and secure access to other markets for European companies and investors. The potential for dividing the EU via infrastructure investments or other forms of funding for individual member states would be greatly reduced if a larger number of foreign and security policy decisions were taken based on qualified majorities. The price would be individual member states forsaking their sovereignty. That should be acceptable if the perimeters of the EU's authority are clearly defined.

In the field of technologically sensitive takeovers of European companies, there are often calls for the European Commission to examine cases of strategic importance and propose a ban if necessary. The member states in question would be asked to take the final decision in such cases. This kind of procedure, which partly exists at the level of member states, is prone to lobby influences and may reinforce protectionism. Moreover, it is difficult to assess in individual cases whether the economic impact of a takeover is reflected in the purchasing price of the company under bid or not. In my view, the priority should be to achieve better conditions for European investors in China. To this end, it may indeed be necessary to at least consider heavier regulation of Chinese investments in Europe.

Secondly, Europe should not try to imitate China's strategy for technological development in the future. Europe is often criticized for lacking a clear industrial policy strategy, targeted funding for "European champions", or large technology firms that are seen to have a promising future. This overlooks the fact that an economy is not the same thing as an individual company. Industrial policies like "Made in China 2025" can easily backfire. State decision-making bodies are often no better, and in most cases even poorer, than private entrepreneurs at identifying and implementing promising investments for the future. An economic policy that creates attractive investment decisions and promotes basic research, start-ups, innovation and cooperation between universities and business without privileging specific

sectors or technologies stands a better chance of success. In addition, many European countries have a tendency to prioritise spending on social and redistribution policies over policies promoting investment, innovation and growth. The welfare state is a key pillar of the European economic model; but this economic model may be undermined if the welfare state becomes too large.

Thirdly, Europe urgently needs to resolve internal conflicts over topics like Brexit and Eurozone reforms and focus more on policy areas that offer opportunities to increase prosperity, such as deepening the European internal market and making defence, foreign and security policy more European. Europe can only realise its growth potential if it addresses these issues. Only then will the European model of a combination of market economy with democracy, the separation of powers and the protection of individual rights be attractive and able to compete with other economic systems.

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