Much ado about nothing?

Fraser Cameron considers the political and economic context of the EU-China investment deal

Introduction

Rarely has a deal aroused so much controversy as the EU-China comprehensive agreement on investment (CAI) that was signed on 30 December 2020. Its defenders argue that it was the culmination of seven years of tough negotiations and achieved the EU's main objectives, further opening the fast-growing Chinese market to EU companies and strengthening commitments on labour rights and sustainable development.

They also point out that the EU had little real leverage as its economy was already much more open than the Chinese market. But what was important was a rebalancing of market access.

The deal has been strongly supported by EU leaders and business. Critics of the deal, including many in the European Parliament, argue that it should have included more stringent conditions on labour rights and that the timing was wrong, coming after China's crackdown in Hong Kong and Xinjiang, and just a few weeks before the start of the Biden presidency.

There are also those who suggested that Merkel pushed the CAI through under strong domestic business pressure, especially the automobile sector, and to have another achievement under the German EU presidency.

Many critics wrongly described the CAI as akin to a free trade agreement (FTA) which it is not. The EU has made clear that an FTA with China will not be on the agenda for years to come. Brussels argues that if the CAI works well for a number of years, then one could consider a scoping exercise for an eventual FTA.

But that process would take at least a decade and would depend on China sticking to its commitments and further substantial changes to the Chinese economy.

The political and economic context

It is important to set the CAI against the overall geopolitical context as well as the EU's own tripartite strategy towards China. On the geopolitical front the main trend is towards increased US-China rivalry which was most apparent in the US tariff war on China and President Trump's sharp criticism of China over the COVID-19 pandemic.

While the Biden administration is currently formulating its policy towards China, initial statements suggest that it will also pursue a tough line regarding Beijing more as a threat than a partner.

Any assessment of the deal will probably have to wait for the first few year's implementation and whether or not China sticks to its promises and whether or not EU businesses see a significant increase in their access to the Chinese market

As Merkel and Macron have made clear, the EU does not wish to be involved in any new Cold War between the US and China. The EU regards China as a partner, a competitor and a rival according to different issues. It thus has an array of different policies and instruments in dealing with China.

These include new mechanisms for screening FDI and state subsidies, autonomous trade defence instruments (anti-dumping), and projected new instruments dealing with procurement and human rights.

The EU argues that the CAI is not the right place to deal with human rights but is rather a *sui generis* agreement with the aim being to rebalance the economic relationship which is taken as increasing market access and improving the conditions for a level playing field.

China, it is argued, will now be bound by rules that it did not previously accept. The EU also defends the deal on the grounds that it is seeking the same concessions granted to the US in the China-US first phase agreement of January 2020, a deal it is argued, detrimental to the interests of the EU.

The EU further rejects the argument that it should have waited to consult the Biden administration as it had no idea how long it would take the new administration to formulate its overall trade policy, especially towards the WTO and China.

The EU argues it needed to bank the concessions offered by China rather than wait. It also argues that CAI is a stepping-stone to discuss China and WTO reform with the US. In contrast to the US-China first phase deal, which was a bilateral accord, the EU secured concessions open to all under MFN rules.

It also believes that acceptance of greater transparency and information sharing were important advances.

China has welcomed the CAI as a major step to strengthen EU-China relations and the multilateral system. It wanted to seal the deal before the new US administration came into office and some Chinese commentators applauded the deal as an indication of the EU taking a different approach from that of the US.

It also wanted to ensure that the EU would not restrict Chinese investment in Europe as some politicians had demanded. It was also a natural progression after the signature of the RCEP and Chinese efforts to conclude a trilateral trade deal with Japan and South Korea.

On the geoeconomics side, the EU recognises the huge importance of the Chinese economy to its own growth prospects. China was the only major country to achieve growth in 2020, despite the COVID-19 disruption, and its prospects for 2021 are far ahead of the projections for the EU or US.

According to Eurostat, in 2020 exports of EU goods to China increased by 2.2% and imports went up 5.6%, while EU trade with the rest of the world dramatically dropped (down 9.4% in exports, and down 11.6% in imports compared with 2019).

The pandemic severely hit transatlantic trade, with exports of European goods to the US falling by 8.2% and imports down 13.2%. As a result, the US is no longer the bloc’s top trade partner in goods and has been replaced by China. EU exports to China in 2020 amounted to €202.5 billion while imports reached €383.5 billion.

China also attracted more FDI in 2020 than any other country in the world. The cumulative FDI flows from the EU to China over the last 20 years have reached more than €140 billion. But this figure is relatively modest with respect to the size and the potential of the Chinese economy.

The EU-China comprehensive agreement on investment (CAI) was signed on 30 December 2020

For Chinese FDI into the EU, the figure is almost €120 billion. Many European countries continue to seek Chinese investment in their economies despite restrictions in some areas such as 5G.

The IMF and World Bank predict that within the next few years China will have the world's largest economy and if current growth rates continue then within two decades its economy will be bigger than the US and EU combined.

It is thus not surprising that despite the criticism over China's human rights record, European business is unwilling to forego the opportunities of the Chinese market.

In a January survey of business sentiment, the EU chamber of commerce in China found that 75% of respondents expected to increase their investments in China during 2021 and only 4% were considering leaving.

Reacting to the uncertainty induced by the threat of decoupling and disruptions caused by COVID-19 pandemic, over half of EU companies are localizing their China operations in order to increase their supply chain resilience and adapting their core technologies to Chinese standards.

It is a similar story with US business. Instead of decoupling financially, the US and China now have one of the largest and fastest-growing bilateral investment relationships in the world. American investors held $1.1 trillion in equity issued by Chinese companies at the end of 2020.

The importance of FDI to China was emphasised by its performance last year, when it attracted $163 billion in inflows and eclipsed the $134 billion attracted by the pandemic-hit US to become the world's largest recipient of foreign inflows for the first time. Japan FDI into China is also increasing at a fast pace.

Benefits of CAI

The EU argues that the main value of CAI is improved market access for European businesses, especially by removing obstacles for investments such as the forced transfer of technology, establishment of joint ventures and IP rights.

There are also provisions on increasing regulatory transparency and non-discriminatory treatment of foreign investors, in particular regarding licensing, standards and subsidies.

Sectors most likely to benefit include manufacturing, new energy vehicles, financial services, healthcare (private hospitals), R&D (biological resources), telecommunications/cloud services, IT services, international maritime and air transport, business, environmental and construction services.

The EU also plays up the commitments regarding state-owned enterprises (SOEs) which play an important role in China's economy. The text states that SOEs 'shall act in accordance with commercial considerations' in their purchases or sales of goods or service and shall treat European enterprises no less favourable than domestic ones.

The EU argues that it secured further commitments on sustainability, climate and the environment, CSR and labour rights. It means that the CAI also exceeds what China committed to in RCEP and the US-China first phase trade deal. The EU notes that these concessions are available to all countries under the MFN process.

It also argues that the CAI will also help in the US-EU-Japan trilateral process pressing China to limit steel output, something it appears to accept in its latest five-year plan.

Criticisms

Critics of the deal argue that China has largely repackaged existing market access openings eg. financial services, automotive sector, abolition of joint venture requirements, etc. and that many of its market access obligations are partially restricted or conditional.

For example, in the telecommunications and cloud services sectors, EU investors still have a 50% maximum participation limit. Investments in private hospitals are limited to eight cities and the island of Hainan.

In the aviation sector, China will open some areas (computer reservation systems, ground handling and marketing services), but aviation rights will not be included and foreign holdings in public air services will not exceed 25% of the total market share.

Another criticism is that the provisions contained in the agreement on the obligation to disclose information about subsidies are limited to subsidies in certain service sectors.

It seems that the CAI will also favour larger EU companies rather than SMEs as the levels of investment required in the sectors covered are substantial.

Critics also allege that the provisions on CSR are weak with China simply recognising 'the important contribution of corporate social responsibility … in enhancing the positive role of investment for sustainable growth.' Reference is also made to the voluntary CSR codes of the UN and the OECD.

Interestingly the CAI foresees specific panels of experts monitoring these provisions and even allows a limited role for NGOs to participate in the proceedings, eg. by submitting amicus curiae briefs.

Mr Butikhofer, MEP, has questioned what these Chinese commitments mean 'in a country where there are no trade unions and where there is no freedom of expression and organization?' The same critic has damned the agreement for the weak commitments on the labour front. China has only agreed to undertake 'on its own initiative, continuous and sustained efforts' to ratify the ILO conventions (C29 and C105) on forced labour.

There is no fixed timetable for ratification. The language on sustainable development is essentially a reiteration of previous commitments under the Paris climate change agreements.

On the EU side, the CAI grants Chinese companies greater access in the areas of energy and renewable energies but there remain restrictions on the sensitive areas of agriculture, fishing, audiovisual, public services, etc.

Dispute settlement

The actual text of the CAI is relatively short, less than 50 pages, reflecting the fact that the agreement does not contain any investment protection standards, such as fair and equitable treatment nor any investor-state dispute settlement provisions.

The EU has said that both parties need more time to agree on these issues, including the creation of a possible multilateral investment court, and will make best endeavours to complete a further agreement within two years.

The agreement provides for arbitration tribunals, composed of persons nominated by the parties, to resolve disputes within 180 days, taking account of WTO rules. If one party fails to accept the decisions of the tribunal, the other party can retaliate by suspending benefits equal to the losses sustained.

Until there is an agreement on investment protection and ISDS, the current bilateral investment treaties between EU member states and China remain in force thus providing on-going legal certainty for both sides.

Institutional framework

A high-level Investment Committee, co-chaired by a European Commissioner and a Chinese Vice-Premier will meet annually to monitor the implementation of the CAI. Decisions are to be taken by consensus and shall be binding on the parties.

Essentially, this Committee will be the main forum for the parties to discuss any major issues and develop the agreement further.

Next steps

The agreement is currently undergoing legal scrubbing before being sent to the Council (qualified majority) and European Parliament (simple majority) for approval. A schedule for the ratification is not yet known, but most likely the CAI will be voted on in autumn 2021.

The legal service of the European Commission indicated that the CAI will be a pure EU agreement without ratification by the national parliaments of the EU. The market access offer will only be agreed in March after further consultations with member states.

Conclusion

The political fallout resulting from the conclusion of the CAI will rumble on during most of 2021. It should not be overblown as EU FDI into the US is ten times more than EU FDI into China. But it is the potential of the huge Chinese market that attracts EU business and financial companies.

Most EU governments and European business circles support the deal. The leading cheerleader is Chancellor Merkel but she is scheduled to retire in September.

Her likely successor, Armin Laschet, is equally committed to the deal but if the CDU has to form a coalition with the Green party which is strongly critical of the CAI, then there may be problems with the ratification.

Many MEPs will also maintain a critical stance towards the deal but in the end the economic arguments relating to increased employment prospects are likely to carry the day. Assuming the CAI is ratified, then the proof of the pudding will be in the eating.

Any assessment of the deal will probably have to wait for the first few year's implementation and whether or not China sticks to its promises and whether or not EU businesses see a significant increase in their access to the Chinese market. ■

Fraser Cameron is a Senior Advisor to the European Policy Centre