



EUROPEAN
COUNCIL
ON FOREIGN
RELATIONS
ecfr.eu

POLICY
BRIEF

THE EUROPEAN INTEREST IN AN INVESTMENT TREATY WITH CHINA

François Godement and Angela Stanzel

SUMMARY

The fallout from the euro crisis led to a desperate rush for liquidity and capital in European countries. In particular, as companies struggled to borrow at reasonable rates and new public debt was curtailed, the so-called periphery of the eurozone came under pressure to seek loans, investment, and buyers for public property, including from China. Since then, more EU member states have joined the competition for Chinese investment in an effort to restart growth. A Bilateral Investment Treaty (BIT) with China, along with a European policy towards foreign investment, will help regulate Chinese investment in Europe as much as it will help European companies access the Chinese investment and public procurement markets and service sector.

China has long resisted BIT negotiations, as it did with earlier talks towards a Partnership and Cooperation Agreement. The possibility of a Transatlantic Trade and Investment Partnership (TTIP) with the US led China to propose a free trade agreement with Europe, but the EU now needs to maximise its positive and negative leverage. It should create special bond financing to attract Chinese investment in the EU and national infrastructure projects, especially in areas where Chinese companies excel – above all, transport, energy, and communications. At the same time, it should show it can do without China by moving ahead with other free trade agreements, starting with Japan, and with TTIP.

The euro crisis created gaps in investment flows between northern and southern, and western and eastern Europe. Figures vary but generally suggest that while northern and western EU member states have recovered from the crisis, southern and eastern European countries are still suffering from it.¹ In Spain, for example, global investment inflows declined from \$29.5 billion in 2011 to \$17.5 billion in 2012. Since 2011, global foreign and direct investment (FDI) flows to Greece, Italy, Portugal, and Spain have more than halved.² The number of new FDI projects in western Europe between 2009 and 2013 increased by 19 percent while the number in central and eastern Europe (CEE) declined by 12 percent.³

The crisis led to a rush for liquidity and capital in European countries.⁴ In particular, sovereigns and corporates needed to increase exports to, and acquire investment from, outside Europe. A lack of intra-European investment, especially from Germany, and the high cost or unavailability of lending to private borrowers put indebted countries under pressure to welcome Chinese investment. This coincided with a diversification of Chinese investment, which is moving away from energy and raw materials in developing countries towards energy

¹ Data is available from Eurostat, UNCTAD, and EU member states.

² UNCTAD Global Investment Trends Monitor, No. 11, 23 January 2013, available at http://unctad.org/en/PublicationsLibrary/webdiaeia2013d1_en.pdf.

³ "Emerging Europe reshaped by the crisis as Central and Eastern European countries lose Foreign Direct Investment attractiveness", EY, London, 19 November 2014, available at <http://www.ey.com/GL/en/Newsroom/News-releases/News-EY-emerging-europe-reshaped-by-the-crisis>.

⁴ See François Godement and Jonas Parello-Plesner with Alice Richard, "The Scramble for Europe", European Council on Foreign Relations, July 2011, available at http://www.ecfr.eu/page/-/ECFR37_Scramble_For_Europe_AW_v4.pdf.

distribution, infrastructure, and mergers and acquisitions for brand names, high technology, and market shares in advanced economies.

Since then, Chinese investment in Europe has increased further. In particular, there has been an increase in Chinese investment in debtor countries such as Portugal, Italy, Greece, and Spain, as well as in central and eastern European countries and France and the United Kingdom.⁵ While Chinese state actors are still dominant in transport, energy, and utilities, private Chinese investors have become very visible in real estate, which they use as a “golden visa” route to EU member states.⁶ Chinese investments in European sovereign bonds in these countries have also increased significantly.⁷ FDI and major mergers and acquisitions (M&A) continue to take place through China’s state enterprises – subsidised by the state financial system. But there has also been an increase in private capital flowing through offshore umbrella companies and real estate holdings.

Thus, whether despite or because of slowing domestic growth, China’s long-term “go-global” growth strategy is still on. Changing economic conditions – in particular, the slightly stronger renminbi – means China increasingly needs to invest in Europe. As more Chinese money flows into Europe, more EU member states are joining the

competition for Chinese investment. China is also worried by the possible extension of anti-dumping measures beyond 2016, when it is officially deemed by Europe to be a “market economy”. It thus has an interest in maintaining an “open door” to European markets – which may explain why it sought a compromise over the solar panel dispute and did not retaliate against the European Commission’s investigation into the telecoms sector. In addition, the global slump in commodity prices will affect countries like Russia and Venezuela, some of China’s favourite destinations for investment and loans, and make mature consumer markets such as the EU look safer in the long term.

This brief explores whether this new situation could also make China more willing to negotiate the Bilateral Investment Treaty (BIT) that the EU has long wanted. It explores recent trends in Chinese investment in Europe that make it even more urgent that the EU negotiates a BIT. But it argues that, in order to negotiate anything meaningful, Europeans need to unify around a negotiating mandate that reconciles their different interests. They should then use both positive and negative leverage in their negotiations with China and prioritise norms and barriers behind borders, investor-state dispute resolution, and transparency of capital flows – issues that are now strategic for future relations with China.

5 Thilo Hanemann quoted in Jamil Anderlini, “Chinese investors surged into EU at height of debt crisis”, *Financial Times*, 6 October 2014, available at <http://www.ft.com/intl/cms/s/2/53b7a268-44a6-11e4-ab0c-00144feabdc0.html#axzz3Lr8SuhA> (hereafter, “Chinese investors surged into EU at height of debt crisis”).

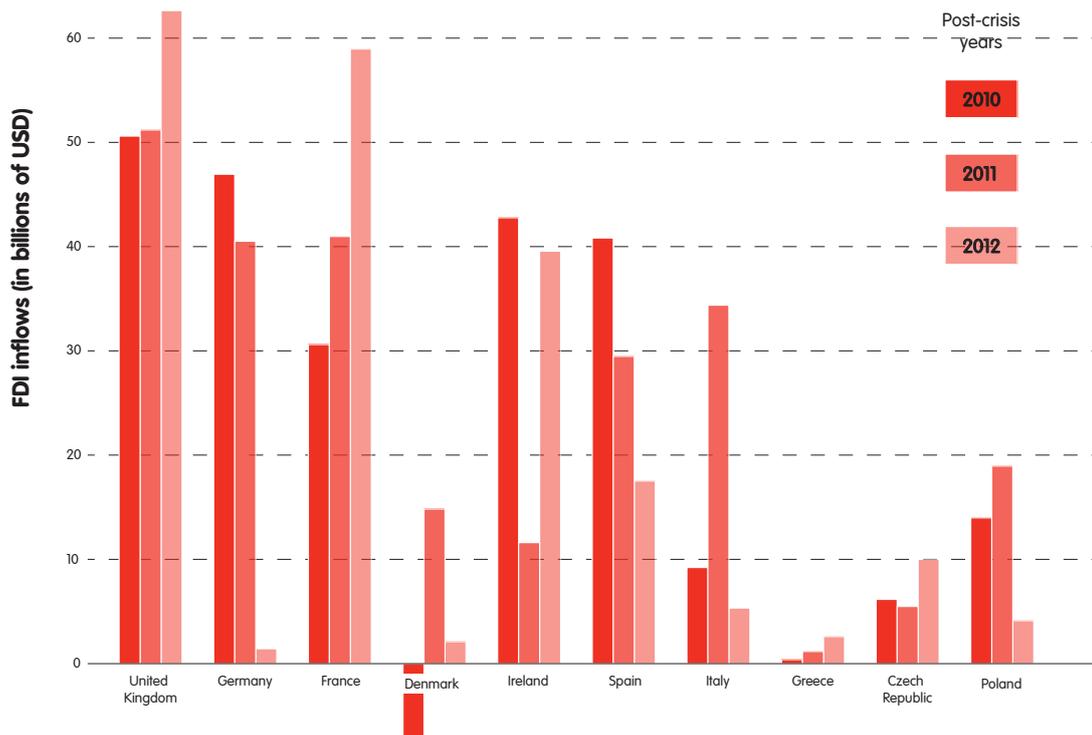
6 Pam Atherton, “News Analysis: The China conundrum”, FT Adviser, 16 October 2014, available at <http://www.ftadviser.com/2014/10/16/investments/news-analysis-the-china-conundrum-wD52lGKnsoxVhHasUuk3vM/article.html>.

7 “Partners or rivals? Chinese investments in Central and Eastern Europe”, Central & Eastern Europe Development Institute, 2014, available at <http://ceedinstitute.org/upload/files/c994d506d9c260e01d96efad4d22bo3a.pdf>.

From the periphery to the core

At the height of the euro crisis, Chinese investment in Europe was above all in the periphery and in particular in infrastructure. The paradigmatic case was the acquisition by COSCO, a Chinese state-owned enterprise (SOE), of a

Post-crisis Chinese Foreign Direct Investment (FDI) in Europe



container terminal in the Greek port of Piraeus, which later turned into a minority stake in the whole harbour. COSCO, which has tripled traffic at the container port, is today part of a consortium applying to buy the remaining 67 percent stake held by the Greek state. In January, the new Syriza government announced that the privatisation of the port would be reviewed and potentially stalled.⁸ Nevertheless, Chinese investors are by now present in major areas of Greece's industries such as shipping and tourism. In June 2014, Greece and China signed a shipbuilding deal worth \$3.2 billion that will be financed by the China Development Bank.

In southern Europe, Chinese investors have now also begun securing stakes in larger companies. In July 2014, State Grid Corporation of China invested heavily in the Italian power grid, buying a 35 percent stake in CDP Reti. The Chinese State Administration of Foreign Exchange also invested an estimated €2 billion in Eni and Enel, two state-controlled energy groups, and bought stakes in Fiat Chrysler, Telecom Italia, and Prysmian Group for a total of €670 million. There have also been Chinese investments in power utility and infrastructure projects in Portugal. In 2011, China Three Gorges Corporation acquired a 21 percent stake in Energias de Portugal and State Grid acquired 25 percent of REN, the national grid operator.

However, Chinese investors have also now moved beyond the periphery and acquired stakes in infrastructure in much of the rest of the EU. In particular, investment in central and eastern European EU member states has increased. At the most recent 16+1 summit between central and eastern European and Chinese leaders, in Belgrade in December 2014, Chinese Premier Li Keqiang announced the establishment of a \$3 billion Chinese investment fund to "encourage Chinese companies and financial institutions to participate in public-private cooperation and ongoing privatisation processes in CEE countries".⁹ A financing package to help cash-strapped countries in CEE through preferential and reduced costs of financing was discussed.

At the 16+1 summit, China, Hungary and Serbia also announced an agreement to construct a railway line from Belgrade to Budapest – part of China's New Silk Route project, which includes a northern road and a southern maritime corridor connecting China with Europe.¹⁰ Chinese investors already have stakes in nuclear reactors in Romania, the chemical industry in Hungary, and ports in Croatia and Bulgaria. Slovenia, which is in the process of privatising its infrastructure, is looking for shareholders for ports, airports, and other infrastructure in the country. China Southern Airlines has expressed interest in buying a 75 percent share of Ljubljana Airport in the capital, while Chinese companies have also expressed interest in buying a 60 percent share of the Mediterranean port of Koper.

8 See "Greek government says to halt Piraeus port sale", Reuters, 27 January 2015, available at <http://www.reuters.com/article/2015/01/27/us-greece-election-privatisation-idUSKBN0L027W20150127>.

9 "China ready to boost economic ties with CEE countries: Premier", English.Gov.CN, 17 December 2014, available at http://english.gov.cn/premier/news/2014/12/17/content_281475025594534.htm.

10 See Dragan Pavlicevic, "China's Railway Diplomacy in the Balkans", the Jamestown Foundation, China Brief, volume 14, issue 20, 23 October 2014, available at http://www.jamestown.org/programs/chinabrief/single/?tx_ttnews%5Btt_news%5D=42992&cHash=1180c27d971be18898233bad9c780edc#.VNPmWcaQtek.

Chinese investors are also increasingly buying into infrastructure in the UK. In June 2014, the China Development Bank signed a framework agreement with Lloyds Bank to encourage Chinese FDI in Britain's energy and infrastructure sectors.¹¹ At the end of 2014, China announced that it would invest £105 billion in British infrastructure by 2025, with energy, property, and transport the biggest recipients.¹² China is also one of the main investors in a consortium led by France's EDF Energy to build the Hinkley Point C nuclear plant. In mid-December 2014, the Chinese company CGN also bought three wind farms in the UK from EDF.¹³

Even France has allowed China to invest in its infrastructure for the first time. In December 2014, the French government announced the sale of a 49.9 percent stake in the Toulouse airport to a Chinese consortium, with Lyon supposed to follow. The public sector was officially said to keep its leverage over airport management, but a secret shareholder pact was revealed that essentially places the Chinese co-owner at the helm for strategic and top personnel issues.¹⁴ On the other hand, France seems to have excluded a Chinese company from bidding for a major Eurostar contract, and unlike the UK will apparently not consider Chinese firms for rail or subway contracts or for the extremely uncompetitive management of its toll roads. The country appears trapped between sovereignty and the fear of a public outcry on the one hand and the need for cash on the other.

In addition to infrastructure, Chinese investment in European commercial and residential real estate – which does not show up in official figures – has increased. For example, Chinese buyers are supposed to be the second-most important foreign buyers of real estate in Paris. In 2014, the listing on the market for €7 million of a luxurious villa in Cannes drew attention, since it belonged to former Chongqing Communist Party chief Bo Xilai, who was sentenced to life for bribery, embezzlement, and abuse of power in 2013.¹⁵ Cyprus, Greece, Portugal, and Spain are also attracting Chinese real estate buyers by offering residency permits to non-Europeans who buy local property totalling a certain amount. In Portugal and Spain, this "golden visa" process requires that an individual or affiliated company buy a property for at least €500,000. In Greece and Hungary, it is estimated to be lower, requiring a €250,000 sale. In Portugal, 1,360 of these "golden visas" have been issued – 81 percent of them to Chinese nationals.¹⁶

11 "UK and China agree £14 billion of trade and investment deals", UK government press release, 17 June 2014, available at <https://www.gov.uk/government/news/uk-and-china-agree-14-billion-of-trade-and-investment-deals>.

12 Gill Plimmer and Lucy Hornby, "China set to invest £105bn in UK infrastructure by 2025", *Financial Times*, 27 October 2014, available at <http://www.ft.com/intl/cms/s/0/501808f6-5b89-11e4-b68a-00144feab7de.html#axzz3RNT1Lkw6>.

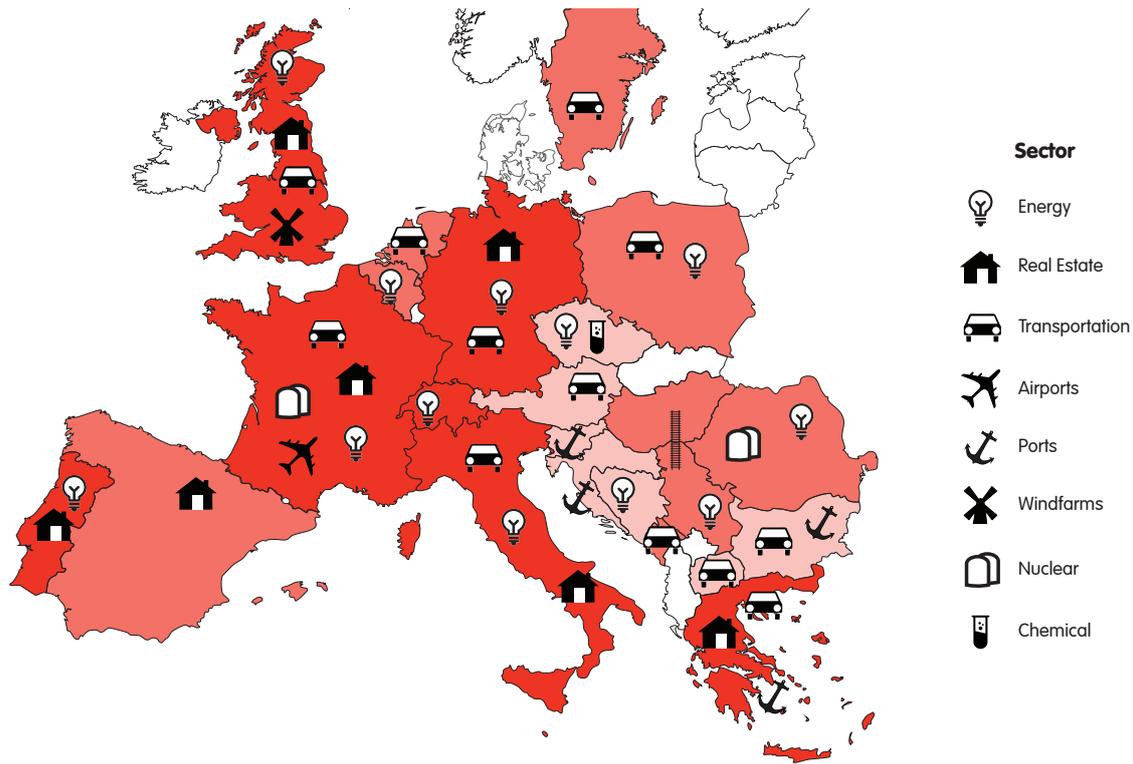
13 "China General Nuclear Unit Buys Stake in 3 EDF UK Wind Farms", Bloomberg, 16 December 2014, available at <http://www.bloomberg.com/news/2014-12-16/china-general-nuclear-unit-buys-stake-in-3-edf-u-k-wind-farms.html>.

14 Laurent Mauduit, "Aéroport de Toulouse: les preuves du mensonge", *Mediapart*, 7 December 2014, available at <http://www.mediapart.fr/journal/france/071214/aeroport-de-toulouse-les-preuves-du-mensonge>.

15 See Nectar Gan, Laura Zhou, and Angela Meng, "Luxury French villa of jailed Chinese politician Bo Xilai 'up for sale at HK\$66 million'", *South China Morning Post*, 22 December 2014, available at <http://www.scmp.com/news/china/article/1667708/luxury-french-villa-jailed-chinese-politician-bo-xilai-sale-hk66-million>.

16 See Peter Wise, "Sea, sun and easy visas lure China buyers", *Financial Times*, 8 October 2014, available at <http://www.ft.com/intl/cms/s/2/d7c1b472-44a6-11e4-ab0c-00144feabdc0.html>.

Chinese Foreign Direct Investment (FDI) in European sectors



Chinese investors have also made their first moves to acquire land in Europe, though initially through countries outside the EU such as Iceland and Norway. The Chinese tycoon Huang Nubo had wanted to buy territory in Iceland in 2011 but was rejected. He then turned his attention to Norway, and reached a preliminary deal in 2014 to buy land worth \$4 million. The appearance of such individual investments in real estate – akin to hot money leaving China – illustrates the need for greater transparency in financial flows between Europe and China. Although the EU is restrictive in regard to offshore financing, large flows of Chinese investments into Europe remain unregistered because they either go through offshore markets and tax havens (Luxembourg remains the first official destination of Chinese FDI to Europe) or are below declaratory thresholds. While the EU has begun to check the activities of offshore markets controlled by some member states and by Switzerland, it does not reach into many other tax havens, including Hong Kong. China has mostly managed to exempt these from oversight in G8 or G20 talks.

China's differential treatment of domestic and foreign investors in this regard will soon make it harder to increase the transparency of Chinese capital flows. The draft of the new foreign investment law, published in January 2015, obligates the offshore shareholders of shell companies that own foreign investment firms in China to declare their identity or be treated as a foreign firm. Thus China may have resolved its own issue of “round-tripping” – that is, Chinese investors moving abroad and back again – while retaining the use of offshore companies to invest outside China. This dual system will mean China has little incentive to cooperate on the transparency of capital flows.

Finally, Chinese investment in European companies – in the core as well as the periphery – has also increased in the last few years. In 2012, for example, the Chinese Sany Group bought the German mechanical engineering company Putzmeister for around \$470 million – the largest direct investment a Chinese company has made in Germany. Most acquisitions of this kind are unproblematic, but there are particular concerns about the activities of Chinese telecoms firms such as Huawei, which has links to the People's Liberation Army and has been banned from bidding for government contracts in the US. Huawei, whose European headquarters is in Düsseldorf, now employs roughly 1,700 staff in Germany.¹⁷ It has plans to invest billions in France and the UK.¹⁸ These developments in Chinese investment in Europe make it even more urgent that the EU negotiates a BIT.

TTIP as a game changer for an EU–China BIT

A BIT is an agreement establishing the terms and conditions for investment, including the level of protection (for example, from expropriation without full compensation) and the number of guarantees (for example, free transfer of capital or fair and non-discriminatory treatment). It can specify the procedures and opportunities available to investors in case of conflict with the host state, including potential recourse to international arbitrators in a process known as investor-state dispute settlement (ISDS).¹⁹ Investment provisions are

¹⁷ See Wei Cen, “Foxconn Employees Strike, Demand Overtime”, Huxiu, 13 October 2014, available at <http://en.huxiu.com/article/1767360190>.

¹⁸ In France, Huawei plans to invest \$1.9 billion on R&D facilities over the next few years, as announced in November 2014. In the UK, Huawei was invited to invest £1.2 billion (including R&D facilities) in 2014. See Shannon Tiezzi, “The UK's China Experiment”, the Diplomat, 3 December 2013, available at <http://thediplomat.com/2013/12/the-uks-china-experiment/>.

¹⁹ Investor-state dispute settlement (ISDS) is an instrument of public international law that allows an investor to bring claims directly against the government of another country before an international arbitral tribunal. It is present in a number of bilateral investment treaties, trade treaties, and international investment agreements. An ISDS

often negotiated into a free trade agreement (FTA) rather than as a standalone investment agreement. But in the case of the envisaged EU–China BIT, it is the other way around: the EU wants to approach the liberalisation of market access within the agreement.²⁰

EU member states have concluded more than 1,400 BITs with third-party countries. Sweden was the first EU member state to sign a BIT with China, in 1982; now all of them except Ireland have one.²¹ Since the Lisbon Treaty made investment policy and negotiations an EU competence, the EU now seeks to replace these 27 treaties with a single EU–China agreement. But the very wide disparities between existing treaties – some of which are more favourable than others to their European signatory – make it difficult even to agree on a negotiating mandate. For example, there is still no agreement on the inclusion of an ISDS clause, which is particularly controversial in some EU member states such as Germany.

An EU–China BIT could trigger further liberalisation of investment flows on a reciprocal basis, and set a new standard for access to investment opportunities with negative lists. Europe is interested in transparency for capital flows and identity of investors, while China has generally turned a blind eye or even encouraged tax havens and opaque offshore circuits. But recent dispositions in the future Chinese law regulating foreign investment through umbrella companies show that Chinese policymakers have their own concerns about the opacity of firms. More broadly, a unified European foreign policy towards China cannot be achieved without some consensus on trade and investment interests. Thus a BIT could be a tool to limit the divergence of interests among Europeans and create the basis for an agreed common approach towards China.

China has long resisted BIT negotiations – as it did with earlier talks on a Partnership and Cooperation Agreement. It believes it has little need for a BIT with the EU because the European market and economies are basically open. Although common rules would provide clarity, the multiple BITs with EU member states that currently exist give it a great bargaining advantage while denying Europe any leverage to open up China itself for investment and public procurement. Rather than a BIT, China would prefer to negotiate an EU-wide FTA. This would provide the occasion to eliminate the risk of anti-dumping action based on unfair subsidies. At present, market economy status from 2016 will eliminate anti-dumping action based on pricing, but not on subsidies.

However, China has come to fear being isolated, as negotiations have begun on a number of mega-trade deals such as the Trans-Pacific Partnership (TPP), the Transatlantic Trade and Investment Partnership (TTIP), and the Japan–EU FTA. In 2013 – in other words, after the EU and the US had laid the groundwork for TTIP,

clause was included in the Comprehensive Trade and Economy Agreement (CETA) with Canada. Signed in December 2014, it has not yet been ratified.

20 “EU and China begin investment talks”, European Commission press release, Brussels, 20 January 2014, available at http://europa.eu/rapid/press-release_IP-14-33_en.htm.

21 UNCTAD International Investment Agreements Navigator, as of October 2014, available at <http://investmentpolicyhub.unctad.org/IIA>.

which will also include a comprehensive investment chapter – Beijing also began asking the EU for an FTA. President Xi Jinping emphasised the goal of an FTA when he visited the EU’s headquarters in March 2014. China has also concluded FTAs with close EU partners such as Switzerland and Iceland, and is enhancing its relations with 16 central and eastern European countries (of which 11 are EU member states). Were China’s political relations with Norway less controversial, they too might have concluded an FTA.²²

China has also begun negotiating a BIT with the US – a far more unified and difficult partner for investment. The US and China had started talks on a BIT in 2008 but only launched negotiations in July 2013.²³ Both countries have now agreed to exchange their proposed “negative list” (a list of companies and industries that are excluded from foreign investment unless specifically approved) in early 2015. This was the first time that China accepted the idea of dealing with all stages of foreign investment, including “pre-establishment” national treatment on the basis of a negative list (exceptions, such as sensitive sectors) and removal of behind-the-border barriers to market access.

China was apparently also prepared to negotiate a BIT with the EU, but did not want to include market access in it. But in 2013 it relented and negotiations were launched at the 16th EU–China summit in November 2013. The summit saw the adoption of the EU–China 2020 Strategic Agenda for Cooperation, which includes BIT negotiations as one of the key initiatives as a step towards a longer-term ambition of signing a deep and comprehensive free trade agreement (DCFTA).²⁴ The EU and China have now conducted three rounds of negotiations.²⁵ The next round is expected to take place as soon as texts outlining the rules and regulations for the BIT negotiations have been exchanged and agreed on by both parties.

The key issues for Europe

The European Commission is still discussing with member states the terms of a negotiating mandate. The key issues include ISDS, market access and protection, and Chinese SOEs.

ISDS

ISDS is a particularly difficult issue for the EU. In particular, there are concerns that the controversy around the inclusion of ISDS in TTIP could “poison the debate between the EU and China”. In particular, fears about

22 See “Cold shoulder: Norway considers avenging Chinese bullying”, *the Economist*, 18 February 2012, available at <http://www.economist.com/node/21547832>; “China-Norway relations remain frosty”, News24 Online, 28 October 2013, available at <http://www.news24.com/World/News/China-Norway-relations-remain-frosty-20131028>.

23 At the Fifth Strategic & Economic Dialogue in July 2013, see “China, U.S. to start negative list BIT negotiations”, Xinhua, 9 July 2014, available at http://news.xinhuanet.com/english/china/2014-07/10/c_133472362.htm.

24 EU–China 2020 Strategic Agenda for Cooperation, released at 16th China–EU Summit, 23 November 2013, available at http://ec.europa.eu/china/docs/eu-china_2020_strategic_agenda_en.pdf.

25 “EU and China begin investment talks”, European Commission press release, Brussels, 20 January 2014, available at http://europa.eu/rapid/press-release_IP-14-33_en.htm.

possible limits to environmental or social legislation have made ISDS unpopular in Europe. If the European Commission fails to include ISDS in TTIP, it may not be able to get a mandate to negotiate it with China either. In some member states – in particular, Germany – there is growing opposition to including ISDS in TTIP.²⁶ European Commission president Jean-Claude Juncker has expressed uncertainty about whether to include ISDS in TTIP.²⁷ New Trade Commissioner Cecilia Malmström initially seemed to follow him in a written statement during her European Parliament confirmation hearing.²⁸ An unambitious TTIP would not incentivise China to make concessions to the EU.

China is different from the US. The US legal system remains open to litigation by all parties, while recourse to courts in China is highly questionable. An arbitration mechanism to settle foreign investor disputes with the Chinese state is therefore particularly important. Not only does the Chinese state have absolute authority over its system of justice, but a decentralised system often puts local courts in the pocket of local interests and cronies. While the recourse to courts is usually permitted by most commercial and investment agreements in China, foreign companies see it as “the kiss of death” to go down that road – even as foreign firms are increasingly taken to task by Chinese authorities.²⁹

Admittedly, an ISDS system would not change this situation completely. It remains difficult to imagine a company seeking arbitration against China. It is more likely that Chinese investors will file a claim against the EU, as the Chinese insurer Ping An did against the Belgian government in 2012 after the value of its stake in Fortis collapsed in the wake of the global financial crisis. Still, European companies would at least have the option and, even if the procedure remained unused, it might provide a deterrent. The ISDS provisions of a BIT are therefore essential to most European companies. Any fallout from the present controversies in US–EU relations would be a serious setback for a meaningful BIT with China.

However, this is exactly what is happening with another international agreement: the Comprehensive Economic and Trade Agreement (CETA) agreement with Canada, which was completed in August 2014 and which includes an ISDS clause but is now held up in the European Parliament. The latest CETA draft also accepts pre-establishment national treatment on the basis of a negative list of reserved sectors. When the agreement comes into force, European companies will be able to bid for Canadian public contracts in areas such as energy, mining, manufacturing, financial services, automotive, aerospace, and transportation, as well as business and professional services.³⁰

26 See “TTIP elephants hiding behind ISDS”, EurActiv, 10 December 2014, available at <http://www.euractiv.com/sections/ttip-and-arbitration-clause/ttip-elephants-hiding-behind-isds-310682>; Maya Rostowska, “Storm in a TTIP-Cup? The EU Debate on ISDS”, the Polish Institute of International Affairs, Bulletin No. 124 (719), 29 October 2014, available at http://www.pism.pl/files/?id_plik=18525.

27 See Jean-Claude Juncker, “A New Start for Europe: My Agenda for Jobs, Growth, Fairness and Democratic Change”, 15 July 2014, available at https://groenlinks.nl/sites/default/files/downloads/newsarticle/PG_EN.pdf; “Jean-Claude Juncker plays with future of EU-US trade deal”, *Financial Times*, 23 October 2014, available at <http://www.ft.com/intl/cms/s/0/3571c8b2-5a0c-11e4-b449-00144feab7de.html#axzz3RNT1Lkw6>.

28 Peter Spiegel, “Malmström vs Selmayr: the tale of the track changes”, *Financial Times*, Brussels Blog, 30 September 2014, available at <http://blogs.ft.com/brusselsblog/2014/09/30/malmstrom-vs-selmayr-the-tale-of-the-track-changes/>.

29 Interviews with representatives of foreign firms in Beijing, October 2014.

30 The full text is available at <http://ec.europa.eu/trade/policy/in-focus/ceta/>.

Market access and protection

A key objective of the BIT is to improve the access that European companies have to the Chinese market, which at present remains limited. In 2012, China published new regulations encouraging investment in areas in which it is dependent on the expertise of Western companies, such as environment, energy, high technology, and healthcare. Meanwhile, investment in areas such as heavy industry and strategic raw materials was restricted or in some cases forbidden. The banking and insurance industry, as well as the domestic service sector, remain very strictly regulated, state controlled, or state owned. Thus the new regulations were a disappointment for European companies.

European companies also had high hopes that the creation of the Shanghai free trade zone (FTZ) would help to open the Chinese market. A “negative list” was produced when the FTZ was set up in 2013, but it was largely the same as the restricted sectors’ catalogue of 2012, and thus a further disappointment to many European (and other) companies.³¹ Although the “negative list” was updated in July 2014, it is criticised for the remaining 139 restrictions on investments, mainly in real estate, medical services, and financial services.³² In addition, the risk remains that the Chinese government terminates projects for foreign investors, without clear post-establishment rules.

Concerns about protection on investments from and in China are not new: the European Commission found last year that 77 percent of European businesses had experienced difficulties when dealing with the establishment of investments in China, including problems with intellectual property and preferential treatment given to state-owned Chinese companies.³³ A 2014 report prepared for the Commission’s trade directorate-general outlined restrictions to foreign investment in China, including the requirement to set up joint ventures with Chinese companies, particularly in the automobile and telecoms sectors, and market entry restrictions in the financial and professional services sector.³⁴ A paper published this year by the European Union Chamber of Commerce in China focuses on recent punitive measures that seem to target mostly foreign companies.³⁵

European small and medium-sized enterprises (SMEs) face particular difficulties when trying to invest in China, since they have only limited influence compared to multinationals. For example, almost all foreign SMEs investing in China acquire loan capital in order to avoid costly and lengthy credit procedures by the State Administration of Foreign Exchange.³⁶ These procedures are a particular problem for

31 Catalogue of Encouraged Foreign Investment Industries, MOFCOM (2012), available at <http://english.mofcom.gov.cn/article/policyrelease/aaa/201203/20120308027837.shtml>.

32 Advisory document on China’s negative list restrictions prepared by O’Melveny & Myers LLP, available at http://www.omm.com/files/Uploads/Documents/SHFTZ/OMM_July%202014.pdf.

33 European Commission proposal on EU–China Investment Relations, available at http://www.europarl.europa.eu/RegData/etudes/note/join/2013/514077/IPOL-JOIN_NT%282013%29514077_EN.pdf (hereafter, European Commission proposal on EU–China Investment Relations).

34 Covington & Burling LLP, “Measures & Practices Restraining Foreign Investment in China”, 10 August 2014, available at http://trade.ec.europa.eu/doclib/docs/2014/august/tradoc_152739_08.10.pdf.

35 “European Business in China Position Paper 2014/2015”, European Union Chamber of Commerce in China, July 2014, available at <http://www.eurochamber.com.cn/en/publications-position-paper>.

36 Unlike common stock, loan capital (or borrowed capital) is money that a company

companies that do not have fixed assets in China and are therefore unable to obtain loans and need to cover running costs to invest. According to a 2013 EURObiz survey conducted by the EU SME Centre, 66 percent of SMEs considered access to finance as their biggest challenge for doing business in China.³⁷ A BIT should therefore aim to facilitate easier access to finance for SMEs in order to overcome the competitive disadvantage they face and increase investment security.

Given the arbitrary nature of an unsettled Chinese legal system that is overseen by the Party-state, market access guarantees, protection, and arbitration procedures will be essential components of a BIT providing greater investment security for European firms. But what can Europe give China in return if Chinese investors already have all the access they want in Europe? This is the issue of “positive reciprocity”. It is of course more difficult to find these positive incentives if Europe has already conceded a lot under previous conditions. Does Europe have any cards left in its game?

Chinese SOEs

There are also concerns about the nature of Chinese investment in the EU, specifically relating to the status of Chinese SOEs. Many of the Chinese companies that invest in Europe are state-owned, and member states’ BITs with China do not include specific guidelines on the practices of SOEs.³⁸ According to Chinese Ministry of Commerce (MOFCOM) data, almost all of China’s largest outward investors continue to be SOEs, accounting for 66.2 percent of China’s total European outward foreign direct investment (ODI) stock in 2011.³⁹ However, private investment is growing. Limited liability companies now exhibiting 23.6 percent and shareholding companies make up 6.1 percent of total European ODI stock.⁴⁰

On M&A, private companies play a bigger role. Between 2011 and 2013, according to research by Deutsche Bank, their share in Chinese M&A activity in Europe rose from 4 percent to over 30 percent.⁴¹ According to MOFCOM figures, the outflow of non state-owned enterprises took up a larger percentage, while that of state-owned enterprises decreased to 40 percent. By the end of 2013, among \$543.4 billion of non-financial FDI, state-owned enterprises took up 55.2 percent, and non-state-owned enterprises took up 44.8 percent – 4.6 percent higher than last year. In 2013, the outflow of non-financial ODI reached \$92.74 billion, of which 43.9 percent was from state-owned enterprises, 42.2

percent was from limited liability companies, 6.2 percent was from joint stock limited companies, 2.2 percent was from joint-equity cooperative enterprises, and 2 percent was from private enterprises.⁴²

European markets, with their lack of restrictions on foreign investment, seem to provide a secure entry point to market for Chinese SOEs. These are a far more potent actor of Chinese investment into Europe than they are in the US, which has many more restrictive mechanisms at its disposal. Not only do these SOEs have access to preferential financing by the state, but also they target the acquisition of technology. The European Commission therefore rightly aims to have provisions for SOEs within any ISDS mechanism in the EU–China BIT.

China may in fact be preparing itself for some of these concerns, whether it is towards a BIT with the US or with the EU. In January, MOFCOM published a draft bill on foreign investment, hinting to a more simple regulatory approval process for foreign investments and equal treatment to foreign-invested companies and domestic companies.⁴³ China will release a new “negative list”, which is reported to be a shorter version of the existing list of restricted and prohibited industries. It is expected that e-commerce, already open for foreign investors in the Shanghai FTZ, will not be on this list.

Positive and negative leverage

China wants an FTA and the EU wants a BIT, while both are negotiating with the US. This might make it seem as if China and the EU have equal leverage. In reality, however, there is an asymmetry between them. China seems to need an FTA mainly to protect what it already has, while the EU needs a BIT to get what it does not have – that is, access to China’s investment, service, financial services, and public procurement markets. While European companies continue to face significant barriers to access in China, European markets are already less restrictive than US or Canadian ones. US legislation such as the Buy American Act explicitly restricts foreign access to public procurement in cases where national security or the control of strategic resources are in question. The only EU member state that has such protective legislation in place is the UK, where the acquisition of media and cases involving national security can be referred to the Competition Commission.

On the other hand, China needs to park its surplus somewhere, and Europe is not a bad spot. Indeed, there are currently few attractive alternatives for China: global commodity prices have dropped, especially in agricultural raw materials; energy prices have also dropped; and interest rates are close to zero.⁴⁴ Meanwhile, as growth continues

borrowers (from banks or other organisations) over a stated period of time and on which it pays fixed interest. See “Foreign Investment Financing in China”, EU SME Centre, April 2014, available at http://ccilc.pt/sites/default/files/eu_sme_centre_guideline_foreign_investment_financing_in_china_april_2014.pdf.

37 “Show me the money: Financing for EU SMEs in China”, EURObiz online, 20 January 2015, available at <http://www.eurobiz.com.cn/show-money-financing-eu-smes-china/>.

38 European Commission proposal on EU–China Investment Relations.

39 Ting Xu, Thieß Petersen, and Tianlong Wang, “Cash in Hand – Chinese Foreign Direct Investment in the U.S. and Germany”, Bertelsmann Foundation, 2012, available at <http://www.bfna.org/sites/default/files/publications/Cash%20in%20Hand%20Second%20Edition%20final.pdf> (hereafter, “Cash in Hand – Chinese Foreign Direct Investment in the U.S. and Germany”).

40 The Rhodium Group found that SOEs and sovereign wealth funds combined owned 72 percent of the 2000–2011 EU stocks of ODI, estimated to be more than \$15 million. See “Cash in Hand – Chinese Foreign Direct Investment in the U.S. and Germany”.

41 See “Chinese investors surged into EU at height of debt crisis.”

42 Joint Report on Statistics of China’s Outbound FDI 2013 Released, MOFCOM, 12 September 2014, available at <http://english.mofcom.gov.cn/article/newsrelease/significantnews/201409/20140900727958.shtml>.

43 “China Proposes Legislative Overhaul of Foreign Investment Regime”, WSGR ALERT, 28 January 2015, available at <https://www.wsg.com/WSGR/Display.aspx?SectionName=publications/PDFSearch/wsgalert-china-proposes-legislative-overhaul.htm>.

44 The euro area interest rate has been 0.05 percent since September 2014. See ECB

to slow at home, Chinese companies are looking abroad to make investments and enter foreign markets. China is increasingly interested in acquiring European technology, knowhow, and established brand names. This is in part because China is seeking to move up the value chain, but also in part because Chinese consumers themselves, who are frightened by the lack of environmental and health standards in their own market, are increasingly seeking foreign brand names that they associate with quality. The reverse oil shock of 2014 – which has also seen a fall in prices for many raw materials – will further raise the attractiveness of geopolitically safe countries, even if they offer an apparently lower rate of return to investors.

Thus China may now have more of an incentive to negotiate a BIT than in the past. But in order to maximise the leverage that the EU has, member states need to coordinate more effectively instead of pursuing bilateral relationships as many currently do. British Prime Minister David Cameron's apparent "charm offensive" towards the Chinese leadership, and in particular his call for an EU–China FTA during his visit to China in December 2013, undercut Brussels and dashed hopes that the UK might play a role as a strategic player in the BIT negotiations. Although Germany views the UK's openness towards China with suspicion, its industry would like to see a softer approach to China by Brussels. While a BIT would also give French companies an opportunity to expand into Chinese markets, the French government has not (yet) appeared to be pushing this as a goal in itself. Agreements made by the 11 central and eastern European EU member states in the framework of the 16+1 summit could also undercut the EU's strategy in the BIT negotiations.

The competition between member states directly affects the BIT negotiations, as it diminishes the EU's leverage, and because China can play on bilateral relations whenever discussions at the EU level stall. Europe must now turn this disunity into a common negotiating position. Whether the European priority is to enable Chinese investment in the EU, to organise the current wave of investment on a European scale, or to get better terms to access the Chinese market, the EU will only succeed in its negotiating with China if it unites behind a common position. The pattern of Chinese investments in Europe gives an overview of each country's positioning on the issue, which can help the EU institutions to build a consensus around continued European openness to Chinese investment and capital (the periphery's main interest) but on the condition of improved market access and treatment by China (the core's interest).

Overall, the EU should take a liberal view of Chinese investment in European infrastructure. In particular, it should seek to encourage Chinese investment in key areas in which Chinese companies excel – above all, transport, energy, and communications infrastructure. At the same time, the EU must find a common position in defining necessary restrictions on acquisitions that affect national security.

In negotiating with China, the EU should use both positive and negative leverage. Positive leverage could include special

European bond financing, which should be opened to Chinese investors for the countries hit hardest by the crisis. The Chinese financial authorities have quickly made public their interest in the infrastructure bonds proposed by European Commission president Jean-Claude Juncker. An EU offer of a "negative list", stating clearly which sectors are not open to Chinese investments (thus increasing transparency and avoiding case-by-case rejection of Chinese investments in the EU), could also make a BIT more attractive to China. Finally, the EU could offer to open some sectors in return for increased market access in China or better guarantees for European companies operating in China.

At the same time, however, the EU should use its negative leverage. In particular, it should show it can do without China by moving ahead with other free trade agreements. It should start by quickly moving forward with the Japan–EU FTA, regardless of negotiations with China. It should overcome the reservations and public debate over ISDS with Canada and the US and move ambitiously towards common norms and regulations. These two initiatives will persuade China that the advantage it already has with free access of goods to Europe is steadily diminishing in value.

Like the EU, China is a global player. Trade and investment talks cannot be viewed in isolation of moves with third parties. Chinese economic agents – from SOEs turning into multinational firms, to sovereign funds or more dispersed private actors – are in a decisive phase of capital internationalisation as China maintains a large current account surplus. China cannot sustain the past pattern of huge outlays in the developing world and on energy and raw materials. Within a decade, it will need to draw down capital for increased social and old-age expenditures. This is therefore the right moment for Europe to encourage China's search for secure income from the European economy, while improving the direct access of European companies to the Chinese market. Europe has learned, as the US has always known, that it needs to be a capital importer and not only a capital exporter. Renewed growth on the European continent needs competition among investors as much as for providers of goods and services.

Monetary Rates, available at <https://www.ecb.europa.eu/stats/monetary/rates/html/index.en.html>.

About the authors

François Godement is the Director of the Asia & China programme at the European Council on Foreign Relations and a Research Associate at Asia Centre. He is also a consultant to the policy planning staff of the French foreign ministry and to the OECD and the EU. His publications for ECFR include *China on Asia's Mind* (2014), *A Power Audit of EU–China Relations* (with John Fox, 2009), and *Xi Jinping's China* (2013).

Angela Stanzel is a Policy Fellow in the Asia and China Programme at the European Council on Foreign Relations. Before joining ECFR in 2014, Angela worked for the German Marshall Fund of the United States in Brussels, the German embassy in Beijing, and the Koerber Foundation in Berlin. Her research focuses on the Chinese economy and politics and on international relations in East and South Asia. Angela has a PhD in Sinology from the Free University Berlin. Her doctoral dissertation was published as *Die Volksrepublik China als Akteur im heutigen Pakistan: Nutzen und Risiken des Aufbaus einer chinesischen Machtbasis in Südasien* (2013).

Acknowledgements

We are deeply thankful to our research assistant Catriona Marshall, who provided her research skills and supported us with the interviews and analysis of the results. Other colleagues at ECFR also require particular thanks, especially Hans Kundnani for his patient editorial work and indispensable advice that helped shape the argument, as well as Sebastian Dullien and Agatha Kratz for sharing their thoughts and ideas on the draft. We are also grateful to Abigael Vasselier, the Asia & China Programme Coordinator, who organised the core events of this project.

We owe special thanks to all interviewees, such as business representatives, officials and academics that we met in London, Berlin and Beijing, for their valuable time and input. We would also like to thank the European Commission in Brussels, the Federation of German Industries in Berlin, and the European Chamber of Commerce in Beijing for sharing their insight on Chinese investment issues.

ABOUT ECFR

The **European Council on Foreign Relations** (ECFR) is the first pan-European think-tank. Launched in October 2007, its objective is to conduct research and promote informed debate across Europe on the development of coherent, effective and values-based European foreign policy.

ECFR has developed a strategy with three distinctive elements that define its activities:

- **A pan-European Council.** ECFR has brought together a distinguished Council of over two hundred Members – politicians, decision makers, thinkers and business people from the EU's member states and candidate countries – which meets once a year as a full body. Through geographical and thematic task forces, members provide ECFR staff with advice and feedback on policy ideas and help with ECFR's activities within their own countries. The Council is chaired by Martti Ahtisaari and Mabel van Oranje.
- **A physical presence in the main EU member states.** ECFR, uniquely among European think-tanks, has offices in Berlin, London, Madrid, Paris, Rome, Sofia and Warsaw. Our offices are platforms for research, debate, advocacy and communications.
- **A distinctive research and policy development process.** ECFR has brought together a team of distinguished researchers and practitioners from all over Europe to advance its objectives through innovative projects with a pan-European focus. ECFR's activities include primary research, publication of policy reports, private meetings and public debates, 'friends of ECFR' gatherings in EU capitals and outreach to strategic media outlets.

ECFR is a registered charity funded by the Open Society Foundations and other generous foundations, individuals and corporate entities. These donors allow us to publish our ideas and advocate for a values-based EU foreign policy. ECFR works in partnership with other think tanks and organisations but does not make grants to individuals or institutions.

www.ecfr.eu

The European Council on Foreign Relations does not take collective positions. This paper, like all publications of the European Council on Foreign Relations, represents only the views of its authors.

Copyright of this publication is held by the European Council on Foreign Relations. You may not copy, reproduce, republish or circulate in any way the content from this publication except for your own personal and non-commercial use. Any other use requires the prior written permission of the European Council on Foreign Relations

© ECFR February 2015.

ISBN: 978-1-910118-27-6

Published by the European Council on Foreign Relations (ECFR),
35 Old Queen Street, London,
SW1H 9JA, United Kingdom

london@ecfr.eu