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Europe and China boost to their economic relations through an investment agreement may fall short of expectations

By Alicia Garcia Herrero

After more than seven years of negotiations, the European Union (EU) and China reached a deal for their Comprehensive Agreement on Investment to go forward at the end of 2020. Such deal is important politically both for the EU and China. The EU reads it as a clear sign of its quest for strategic autonomy from the United States (US) after the Trump administration severaly damaged the Transatlantic alliance. For China, it offered a clear signal to the US that it would not succeed in isolating what is meant to become the largest economy in the world. This should be seen all the more impacting as it was come only two months after China's signing of yet another landmark regional trade agreement with 10-members of the Association of Southeast Asian Nations, Australia, Japan and South Korea, namely the Regional Comprehensive Economic Partnership (RCEP). Suddenly, it looks as if the then U.S. President-elect Joe Biden has been left alone in his pursuit to contain China even before he was sworn in on Jan. 20 this year.

Still, RCEP and now the CAI have their limitations. When it comes to CAI, much of what has been written relates to the lack of enforcement for China regarding international conventions on labor -- including forced labor -- but much less attention has been paid to the economic consequences of this deal. Alas, the reason for that might be because the deal amounts to so little.

To start, the purpose of CAI is limited to foreign direct investment and contains no trade clauses. While some aspects of the deal are about more than market access, including sustainability, climate change, international conventions and labor, those provisions remain general and contains limited enforcement possibilities. Investment into European companies is particularly important for China at the current juncture since the market remains relatively more open than any other developed economic area, certainly more than the US, Japan or South Korea and, increasingly, even compared to Australia. In fact, China has clearly stepped up its purchases of European companies in the last few years, being the most important target and with special focus in the industrial sector.

Within that narrower scope the main objective, from the European perspective, really is to improve market access for European companies operating -- or intending to operate -- in China and to ensure a level playing field when they do, as well as reciprocity. Based on that yardstick, the question is whether CAI fulfills such expectations and the answer is hardy so.

If we start with the level playing field, China's market remains much more closed to EU companies than the EU market is for Chinese companies although some improvements have been achieved China's new foreign investment law (FIL) thanks to a shorter negative list. In other words, the number of sectors that remain protected from foreign competition has been shortened although it remains stubbornly high, namely 33. It should be note that the China's push for a shorter list of protected sectors is not necessarily a consequence of CAI as the US has been pushing for it in its high economic dialogue with China for years and, especially, in the negotiations for the Phase 1 deal.

Beyond China's new FIL, an attempt has been made to address the issue of subsidies harming European companies operating in China, but it is really just that: an attempt. There are a number of reasons for that. First of all, CAI improves transparency on subsidies but it only includes an enforcement mechanism for subsidies on services, leaving enforcement against subsidies in the manufacturing sector as they was, i.e., at the World Trade Organization (WTO). The WTO's very poor track record to due with this issue and the fact that most of the EU investment in China is in manufacturing shows the limitations of the agreement reached. Secondly, even within the service sector, the enforcement mechanism is only as a state-to-state dispute settlement (SSDS), whereas no investor to state dispute settlement (ISDS) is envisaged. This als means the existing bilateral agreements between each of the 27 EU member states and China will need to remain in place so as to guarantee the continuation of the ISDS provisions with China at each country's level.

As regards the favorable treatment of state-owned companies (SOEs), no working concept has been included to measure the distortions stemming for their favorable treatment by the Chinese government. The best known concept, competitive neutrality, which had long been pushed by the International Monetary Fund (IMF) as well as the Trump administration, has excluded from CAI. Still, on the positive side, CAI includes a clear definition of SOEs as commercial entities, which was missing in China's WTO accession.

Secondly, on market access, only a few concessions have been made bilaterally and all of them are limited. The three main sectors where concessions have been made are electric vehicles, telecommunications and private hospitals. For the former, it only applies to new investments in electric vehicles and for a minimum amount of 1 billion euro per deal.and only. As for telecommunications, EU investment remains capped at below 50%. For private hospitals, control has been granted in eight provinces but limited to the existence of enough demand and with the condition to be stuffed by Chinese nationals.

Finally, reciprocity is not even mentioned in the agreement although it has bee implicitedly applied to renawable energy but which each EU member state should open to Chinese investment in the space of renawable energy for up to 5% of total market share with the same being true for China. It goes without saying that the huge subsidies received by Chinese players in that sector and the size of the sector by now make it close to impossible for foreign companies to compete.

Beyond the rather limited nature of the concessions made by China into CAI, it is important to note that China has already protected itself by rushing a National Security Law on Dec. 19, right before getting CAI approved, to fend off foreign investment whenever it harms China's national security. The EU, instead, will need to wait to finalize its legal arsenale, in particular the legislation on foreign subsidies harming the single market with an implicit focus on China.

Moving to the issues included in all second generation EU trade and investment deals, namely labor regulations and environmental goals, they are clearly covered but with looser ends on both fronts than in previous agreements, such as Canada, Japan, South Korea or Vietnam.

All in all, CAI is one step forward for the EU and China to increase their investment relations. It is important politically as it allows the EU to test its intention to become more autonomous from the US in its strategic decisions and also China to build on its alliances, including with areas that have long been US allies, such as the EU. However, the deal is rather limited in scope, even within the investment space. The sectors opened by China are few and, even within those, with constraints. A level playing field for EU companies in China remains illusive although some more degree of transparency on subsidies and SOEs has been achieved. Investor protection is still a weak point as no agre agreement has been reached so far which forces the EU to keep its bilateral agreements between each member state and China for dispute settlement. In essence, although most analysts have focused on the provisions related to labor protection and climante change, the reality is that the economic benefit of CAI for Europe remains limited.

Finally, recent complications related to the EU's decision to impose Xinjiang related sanctions on targeted individuals and China's retaliation against some EU Parlamentarians and institutions have led to the EU Parliament's decision to put off any deliberation on CAI until sanctions are lifted. In other words, the clash in values has temporarily put CAI on ice. By the time it is brought back for discussion, it will be even more important to count with more clear benefits from the perspective of European investors. This is particularly true given the clear change in tone from the new US administration as regards the importance of its strategic allies, such as the EU.

Alicia García Herrero is the Chief Economist for Asia Pacific at Natixis. She also serves as Senior Fellow at European think-tank BRUEGEL and Research Fellow at Real Instituto Elcano, and is currently Adjunct Professor at the Hong Kong University of Science and Technology. Finally, Alicia is an advisor to the Hong Kong Monetary Authority's research arm (HKIMR) and the Asian Development Bank (ADB) as well as a member of the board of the Hong Kong Forum.

Alicia holds a PhD in Economics from George Washington University and has published extensively in refereed journals and books (see her publications in ResearchGate or Google Scholar. Alicia is also very active in international media (Bloomberg and CNBC among others) as well as social media (Twitter, LinkedIn and Weibo) As recognition of her leadership thoughts, Alicia has recently been nominated TOP Voices in Economy and Finance by LinkedIn.

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HKUST IEMS INSTITUTE FOR EMERGING MARKET STUDI

T: (852) 3469 2215
E: iems@ust.hk
W: http://iems.ust.hk
A: Lo Ka Chung Building, The Hong Kong University of Science and Technology, Clear Water Bay, Kowloon

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