8. Examining Europe-China connectivity on trade and investment: The case of the Comprehensive Agreement on Investment (CAI)

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Introduction

Trade and investment have traditionally been the driving forces behind Europe-Asia connectivity. Since the mid-1990s, Asian markets have become increasingly important for the EU's global competitiveness and socio-economic welfare position. This was clearly stated by the European Commission in its 2001 Communication on Asia which maintained that 'the EU's role in Asia is to pursue market opening for both goods and services and to overcome obstacles to European trade and investment… [since] active participation for European companies on Asian markets… can contribute to providing qualified jobs for European workers and help the European industry to remain globally competitive'.[1] Back in 1993, the German government had put forward a new strategy towards Asia, advancing the idea that Europe's global competitiveness and economic security would increasingly depend on European companies' capacity to enter into the thriving Asian markets.[2]

Throughout the 1990s, there was a dramatic surge of trade and investment relations between the EU and Asia. At the turn of the millennium, the EU would become Asia's second most important economic partner – behind China, but ahead of the US and Japan.

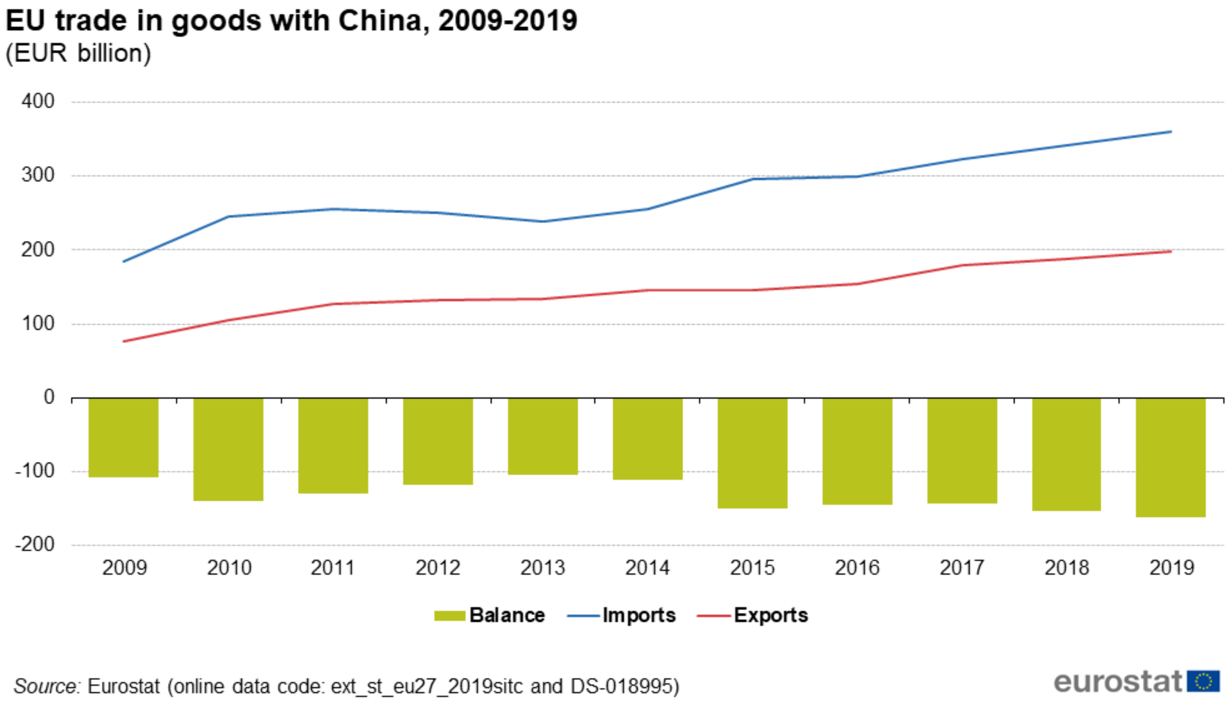
China has become the cornerstone of Europe's trade relations with Asia. In 2019, Beijing accounted for 11 % in extra-EU exports of goods, becoming the EU's second most important trading partner. Moreover, two-way investments have also surged. To provide a legal framework – currently absent – to their burgeoning economic relations, Brussels and Beijing announced the formal conclusion of the EU-China Comprehensive Agreement on Investment (CAI) at the end of December 2020. If ratified, the CAI would boost trade and investment relations between the EU and China. It would also have profound implications for the United States which is actively working to create a common front with the European allies to counter

Beijing's increased self-confidence and assertiveness. Although CAI faces an uncertain future, it was announced only a few weeks before the Biden administration entered into office, as a sign of Europe's determination to promote its 'strategic autonomy' towards Asia.

This chapter focuses on the CAI as an example of the opportunities, and pitfalls, of fostering EU-China connectivity on trade and investment.

EU-China economic connectivity

Economic considerations have traditionally been the main driver of the Sino-European relationship.[3] In 2019, China and the EU traded more than €1.5 billion in goods each day. The EU is now China's most important trading partner, although China ranks number two for the EU, after the US, if both trade in goods and services are considered.



Updated graph (2020/21): https://ec.europa.eu/eurostat/statistics-explained/index.php?title=China-EU_-_international_trade_in_goods_statistics

The COVID-19 pandemic which begun in early 2020 led to a strong decline in trade in the first and second quarters of that year. Between the first quarter of 2019 and the second quarter of 2021, the EU's share of imports from China increased by 4%.[4] China's growing share of imports and exports means that in 2021 Beijing overtook the US as the EU's largest trade in goods partner.[5] However, while the EU imported fewer goods from the US, the relationship remains very strong, particularly when services are included in the statistics.[6]

In recent years, there has been a surge of Chinese investments in the old continent. According to the China Global Investment Tracker, a joint project between the American Enterprise Institute and the Heritage Foundation, China invested nearly $164 billion in Europe between 2005 and 2016. During that same period, it invested $103 billion in the United States. According to the Rhodium Group, a New York based consultancy, Chinese FDI in the EU has increased by almost 50 times in only eight years, from less than $840 million in 2008 to a record high of $42 billion (€35 billion) in 2016. Although Chinese investments in the EU are still comparatively low, they have been evolving rapidly and increasing at unprecedented growth rates.[7]

In the last years, a growing number of scholars and policy makers have begun to argue in favor of more conditionality in EU-China relations, in particular on economic and trade issues.[8] In the same vein, the European Parliament, a number of national Parliaments, and some political forces within EU Member States have stepped up criticism vis-à-vis the Chinese regime and its trade practices, in particular China's lack of reciprocity. Beijing limits foreign investment in its domestic market for almost all sectors. European businesses consistently face difficulties in entering the market, while Chinese companies often receive help from the government, through subsidies or simpler procedures, for example. Foreign companies particularly those with recognised brands and technologically advanced products, are required to share their expertise before they are allowed into the market at all. European investors routinely point out the regulatory and administrative burden that foreign companies have to face in China. While the country is the EU's second largest trading partner, it also has important investment barriers. These include joint venture requirements, market entry restrictions, obligations of technology transfer as well as unjustifiable technical regulations.

China represents a serious economic and trade challenge to Europe, due to its state-dominated economy and its unfair trade practices, which have contributed to de-industrialisation and a declining standard of living across some parts of the old continent - a situation that European countries share with other developed nations, including the United States. Growing imbalances between Europe and China led France, Germany, and Italy to ask the European Commission, in February 2017, to rethink the rules on foreign investment in the

EU. This led to the adoption of a screening mechanism which is intended to help the European Commission and the EU member states to evaluate whether a foreign investor is in reality controlled by a third country government.[9] This is clearly aimed at Chinese state-backed enterprises. The screening mechanism makes it more difficult for foreign investors to acquire expertise and technology that could be used to produce goods sold at lower prices. It was a message to Beijing about opening up access to its markets, at a time when the two sides were negotiating the CAI.

In the same vein, the policy paper on China issued by the Federation of German Industries (BDI) in January 2019 - a document which considerably influenced the EU's policy paper on China issued in March 2019 - argued in favour of a more assertive position vis-à-vis Beijing on trade and investment.[10] At the same time, numerous industrial and business associations across Europe continue to be attracted by China's huge domestic market and its expanding middle class which represents a formidable opportunity for many European companies, some of which have shifted production to China to take advantage of lower production costs and global supply chains.

To provide a legal framework to the growing EU-China investment relations, the EU decided to push ahead with the CAI - a landmark agreement on investment reached in principle by Brussels and Beijing on 30 December 2020, after seven years and 35 rounds of negotiations.[11] However, this is not the end of the process which requires actual signature by China and the EU and ratification by the European Parliament. The announcement of the deal triggered an intense debate, as the CAI has found both supporters, but also opponents, inside Europe. It was hailed as a highly beneficial accord for world trade by China, and as a break-through in locking-in China's hitherto opening up and its concessions in the areas of 'market access', 'level playing field' and 'sustainable development' by the European Commission - but met with harsh criticism from the US, where the new Biden administration was not yet inaugurated and saw in it a victory by China in trying to divide the transatlantic allies.

The CAI is currently frozen due to the spat around the situation in Xinjiang, but the debate around it – and the eventuality of its ratification - is far from being over. On 20 May 2021, the European Parliament voted, by an overwhelming majority, to suspend its ratification.[12] The move came after Beijing had imposed retaliatory measures against EU members of Parliament for their support of sanctions against Beijing for its oppression of the Uighur population. The Chinese sanctions imposed in March 2021 on several European entities and political representatives, including five members of the European Parliament and the Subcommittee on Human Rights, were a retaliatory act in response to the EU decision to enact restrictive measures against four Chinese officials over human rights abuses against the Muslim Uyghur minority in the Xinjiang region.[13]

The European Parliament's decision to freeze the CAI reflects growing disenchantment over the past years with China among European lawmakers who – following the sanctions - are determined to stand up more firmly to Beijing. Still, China remains Europe's second largest trading partner and vital engine of world growth, and any moves against Beijing could open the door to escalating economic retaliation - a prospect that may limit how far European governments and the European Commission are willing to go to pressure China. In fact, various EU governments are seeking to resurrect the CAI, since many industrial associations across Europe support the deal, viewing it as an opportunity for European companies to enter and/or acquiring growing shares of the Chinese market.

The debate on CAI

According to the Chinese government, the CAI is the first economic and trade agreement in which China has made commitments in the form of a negative list in all sectors, including services and non-services, demonstrating the country's determination to promote a wider, broader and deeper opening-up to the outside world. In Chinese eyes, the deal intends to further promote China-EU investment cooperation and, consequently, foreign direct investment inflows and outflows. More precisely, the CAI is a very important policy tool to attract FDI by creating a stable and predictable business environment. According to the Chinese Ministry of Commerce, the EU is China's third largest source of FDI and fourth-largest destination for outward FDI in terms of bilateral FDI stocks. The Chinese government views the CAI as a balanced, high-level and mutually beneficial investment agreement. It does not only set up a new legal framework for China-EU economic and trade relations, but also provide stability for China-EU bilateral relations in an uncertain world under major changes.

Some Chinese scholars go even further as they consider CAI as a milestone that could possibly contribute to structural economic and even political changes in China, an aspect generally overlooked or downplayed in European debates. The idea is that the synergies generated by CAI, the domestic socioeconomic changes that it will bring and Chinese leaders' self-consciousness about the necessity of these changes may set the agenda of China's domestic reform, countering thus the predominant view in the West about the slow pace of reform in the country under Xi Jinping.[14]

According to the European Commission, China has made commitments on various points of interest to the EU, including in the form of a negative list in all sectors. This is the main reason why EU officials assert that the agreement is "substantial" (a condition imposed by the EU to close a deal with China). On market access, progress is hard to deny: several sectors are now open to European investors, such as R&D in biological resources, telecommunication/cloud services, international maritime transport, or air transport-related services. By contrast, liberalisation commitments remain limited in agriculture, fisheries, mining, and energy. Also, several constraints imposed so far on European investors, such as quantitative restrictions, equity caps or joint venture requirements, are eliminated in a broader range of sectors (automotive, financial services, computer services, environmental services, or private hospitals in key Chinese cities, among others). This is progress, from a European perspective.

On levelling the playing field, the picture is less rosy: The major commitments relate to the discipline imposed on State-Owned-Enterprises (SOEs), transparency in subsidies, and the elimination of forced technology transfers, though China's track-record in implementation on all these issues raises doubts as to its ability to turn these promises into reality. The CAI makes explicit reference to the integration of environmental sustainability considerations in the bilateral investment relationship (with a reference to the implementation of the Paris Accord on climate change), as well as references to labor standards. The former addition is particularly noteworthy as this is the first time that China has agreed to such ambitious provisions with a trade partner. However, the two sides only commit to facilitating and encouraging investment in environmentally or climate-friendly goods and services generally without further binding provisions. The implementation of CAI – once adopted – will be the real testing ground of all these commitments.

The European business community in China is largely supportive of CAI. Joerg Wuttke, President of the European Union Chamber of Commerce in China has argued that the CAI makes marginal, though measurable, improvements in market access, recognizing that the biggest gains are the meaningful expansions of the provisions on a level-playing field for the thousands of European companies already in China, while setting a legal foundation at the EU-

China level that is currently absent.[15] Representatives of various business associations across Europe see the CAI as an opportunity to outcompete US companies in the Chinese market. The deal may also allow the Chinese government to counter the shopping list contained in the US-China 'phase one' deal negotiated under Trump and maintained by the Biden administration. With the CAI, the EU applies multilateralism and WTO rules, in stark contrast to Trump's trade deal imposed on China invoking 'national security' considerations.

Inside Europe, the main proponents and drivers of the deal have been former German Chancellor Angela Merkel and French President Emmanuel Macron. The latter had originally hoped to seal the deal with pomp by hosting Xi Jinping in Paris during France's Presidency of the European Council in the first half of 2022. Following the Chinese sanctions and the freezing of the deal, both Germany and France have taken a step back, though their hopes about resurrection of the CAI have not disappeared. On 1 April 2022, during the 23rd bilateral Summit between the EU and China, the two sides called for the ratification of their frozen investment agreement "as soon as possible".

Debate about CAI within EU member states has been uneven. In a few countries, some voices have raised concerns about the content of the deal and its timing, while in others the CAI has gone largely unnoticed. Overall, the EU member states' stance on CAI reflects their general policy towards China. In the last years, the majority of member states' attitude towards Beijing has hardened, due to China's growing assertiveness and diminished prospect for the country's liberalisation process. Furthermore, EU member states' positions on CAI are not only dictated by their relationships with Beijing, but also by their level of strategic closeness and cooperation with the United States.

To be ratified, the CAI needs unanimous support from EU member states and a favourable vote by the European Parliament. In mid-July 2021, the European Parliament underlined the conditions to be met before the legislative gives its consent to the CAI. The conditions are listed in a report prepared by the foreign affairs committee of the European Parliament which calls for using the CAI as a leverage instrument to improve the protection of human rights and support for civil society in China.[16] The pre-ratification commitments listed in the report include a timetable for China's ratification and implementation of key labour laws and concrete measures towards putting an end to human rights violations against the Uyghur minority in the country. It also demands a recommitment by China to uphold its international commitments to Hong Kong. Moreover, the report takes into consideration the new transatlantic climate on

China made possible by the arrival of the Biden administration.[17]

In addition to criticizing China, lawmakers have also urged the EU to step up relations with Taiwan – the island country sitting at the junction of the East and South China Seas - that Beijing claims to own under the 'One-China' principle. On 21 October 2021, the European Parliament adopted a *Recommendation* to the Vice-President of the Commission/High Representative of the Union for Foreign Affairs and Security Policy on EU-Taiwan political relations and cooperation. Adopted by a majority of 580 MEPs, with 26 against and 66 abstentions, the document underlines the urgent need to launch an 'impact assessment, public consultation and scoping exercise' for an EU-Taiwan Bilateral Investment Agreement (BIA). The report also expresses grave concern over China's continued military belligerence, pressure, assault exercises, airspace violations and disinformation campaigns against Taiwan, urging the EU to do more to address these tensions, to protect Taiwan's democracy, and the island's status as an important EU partner.[18]

Besides the question of Taiwan, since early 2022 there has been a surge of negative attitudes towards Beijing across Europe – a dynamic that could delay ratification of CAI. Following Russia's invasion of Ukraine, the main opposition to the EU-China investment deal is now coming from Central and Eastern European (CEE) countries with which China has worked in the past to strengthen ties through its Belt and Road Initiative. Some of these countries have begun changing their stance toward Beijing, finding that the economic benefits coming from China is not as great as they had expected. Lithuania, in particular, has been increasingly critical of China. At the end of 2021, the Baltic state set up a representative office in Vilnius that carries the name Taiwan. This triggered Beijing's campaign of economic coercion against the Baltic state. As a response, the EU brought the case to the WTO, hoping to solve the Lithuanian crisis through dialogue with China.

China's retaliation against Vilnius was also in response to the Baltic state's pulling out of the 17+1 grouping – a China-led format founded in 2012 in Budapest with an aim to expand cooperation between Beijing and CEE countries. Lithuania is not alone, as Slovenia and the Czech Republic have also voiced criticism of China and strengthened relations with Taiwan in the first months of 2022. In addition, some political forces in Western Europe have also stepped-up criticism of Beijing, demanding that CAI remains frozen for the foreseeable future.

Conclusion

The ratification of CAI remains in the balance. The initiatives taken by the MEPs in 2021 are in line with the long-standing tradition by the European Parliament to take positions more critical of China than other EU institutions - such as the European Commission and the European External Action Service (EEAS) - as well as EU member states which tend to seek compromise with China for fear of retaliation. It also demonstrates how Europe continues to be split on its China policy: both within – i.e., among EU member states and between EU institutions – as well as on the outside, since Brussels continues to oscillate between closer cooperation with the US on Beijing-related challenges and the pull of the Chinese market.

The more principled position of the European Parliament raises an important question: how far can Europe's connectivity with China on trade and investment go, considering that the human rights' situation inside the Asian giant is not only worsening, but Beijing is now exporting its authoritarian model around the world? The critical position of the European Parliament on the EU-China investment deal coupled with growing opposition to it coming from Lithuania and other Central and Eastern European (CEE) countries seem to be advocating a temporary halt to EU-China connectivity, sharing some similarities with the United States which is intent on decoupling from Beijing. It remains to be seen whether a more principled stance will prevail in Europe, thus leading the old continent to reduce ties with China - or whether Brussels will continue to engage Beijing and eventually ratify the CAI.

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