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EU-China Investment Deal

A strategic win for both sides

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Economics - China

- The EU and China have reached a new agreement on investment…
- …that aims to reduce investment restrictions, ensure fair competition, and uphold sustainable development commitments
- Such reforms should help to deepen bilateral investment linkages and boost China's long term growth

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The EU and China reached a Comprehensive Agreement on Investment (CAI) in principle on 30 December 2020. The deal, which began discussions in 2014, comes after 35 rounds of negotiations and aims to address longstanding barriers to investment between the two markets. Notably, the CAI will help to:

- Expand bilateral investment flows by reducing restrictions to foreign investment such as joint venture requirements, particularly in China
- Establish a level playing field between local and foreign investors by ensuring that SOEs follow commercial considerations, increasing transparency around state support, and banning forced technology transfers
- Promote sustainable development via provisions to uphold labour and environmental standards

Once finalised, the CAI could provide new opportunities for cross-border investment between the EU and China, which currently remains relatively weak compared to bilateral trade flows. Bilateral goods flows reached over USD700bn in 2019. It also represents a strategic win for both parties amid ongoing US-China trade tensions. EU companies will benefit from expanded access to the Chinese market, while the deal will help to lock in existing commitments for Chinese companies in the EU.

However, the CAI is not a comprehensive trade deal. Therefore, we expect the near term benefits of the deal to be somewhat limited, although improved relations could boost sentiment and increase trade flows modestly. Longer term benefits from the deal could stem from increased productivity gains for China as a result of increased knowledge and technology from investment flows. Moreover, the EU is an important source of technology and advanced machinery for China, with machinery and equipment accounting for 30% of imports from the EU. The deal may also help to accelerate structural reforms in China, which could increase innovation, encourage healthy competition, and lead to a more effective allocation of resources. Sustainable development commitments may help boost human capital growth in the longer run if enforceable.

In terms of next steps, the EU and China will now work to finalise the details of the deal. Parties are aiming to ratify the agreement by the end of this year so it can take effect in early 2022.

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A deal in principle reached

After nearly seven years of negotiations, the EU and China reached a Comprehensive Agreement on Investment (CAI) in principle on 30 December 2020. This reports looks at the content of the deal, the current state of EU-China economic linkages, and trade and economic implications of the CAI.

Details of the agreement

Tackling barriers to investment
The CAI consists of four key elements: market access provisions, commitments to ensure fair competition between foreign and local businesses, sustainable development provisions, and an effective implementation and dispute settlement mechanism. To note, the legal text has not yet been finalised.

Ultimately, the CAI aims to provide regulatory certainty to EU and Chinese businesses operating in each other's markets by reducing barriers to bilateral investment such as quantitative restrictions, equity caps or joint venture requirements, and by increasing transparency around subsidies and other regulatory measures.

We summarise key elements of the agreement in principle below:

- **Market access:** Both parties have agreed to liberalise investment across various sectors. This includes market access commitments (e.g. obligations to not impose quantitative restrictions such as limiting the number of licenses or branches), and provisions around national treatment (i.e. commitments to not discriminate between foreign and local businesses such as via joint venture or nationality requirements). Parties will also include a "ratchet clause", which means that any future liberalisation of existing measures will be automatically applied.
- **Chinese non-services sectors**: China has notably committed to expand market access for EU businesses in the manufacturing sector, including for the production of electric vehicles (although this may be restricted to new manufacturers),[1] chemicals, telecommunications equipment, and health equipment. It will also make limited commitments in agriculture, fisheries, mining and energy. According to the European Commission, this is the first time China has agreed such far-reaching provisions related to the manufacturing sector. This is a key win for the EU as the manufacturing sector accounts for more than half of EU investment in China.

[1] South China Morning Post, "China-EU investment deal: 'landmark' treaty greeted with a shrug by underwhelmed analysts", 31 December 2020.

- **Chinese services sectors:** China will expand market access across a range of service sectors. Notably, it will remove joint venture and equity caps for banking, and lift joint venture requirements for private hospitals in key Chinese cities including Beijing, Shanghai and Guangzhou. China will also lift the investment ban for cloud services, enabling EU companies to invest up to a 50% equity cap. Under the deal, EU companies will also be able to invest in cargo handling, container depots, and maritime agencies in China without restriction. China will remove joint venture requirements in a range of service sectors such as real estate, rental and leasing, advertising, market research, management consulting and for various environmental services. Joint venture requirements and foreign equity caps will be removed for banking, trading in securities and insurance (including reinsurance), and asset management. In addition, China will open up auxiliary air transport services such as computer reservation systems and ground handling. It will also remove its minimum capital requirement for rental and leasing of aircraft without crew.
- **EU market access:** The EU is already relatively open to investment from China. For its part, the EU will expand access to some manufacturing sectors beyond its World Trade Organization (WTO) commitments. However, it will refrain from liberalising sensitive areas such as public services, critical infrastructure and technologies. Policy space will also be preserved in sectors such as agriculture, fisheries and mining.
- **Temporary movement of people:** Managers and specialists of EU and Chinese companies will be allowed to work for up to three years in their subsidiaries in the other party without restrictions. Representatives of investors will also be able to visit each other's markets freely prior to making an investment.
- **Level playing field:** Parties have agreed various provisions to make investment fairer.
  - **State owned enterprises (SOEs):** The deal requires SOEs to act in accordance with commercial considerations and not to discriminate against companies from the other party when they buy or sell goods and services. Parties will also be obliged to share information around whether SOEs comply with commitments under CAI.
  - **Forced technology transfers:** Parties have agreed to ban various investment requirements that compel transfer of technology, and to prohibit state interference in the licencing of technology. The deal will also include disciplines to protect confidential business information (e.g. intellectual property and trade secrets) collected by administrative bodies from unauthorised disclosure.
  - **Subsidies:** The deal goes beyond WTO commitments by imposing obligations around transparency of subsidies in service sectors. It also includes provisions for both sides to share information and consult on specific subsidies that could negatively impact the investment interests of the other party.
- **Domestic regulation:** Parties agreed to ensure that licensing and qualification requirements and procedures are publicly available and easily understandable.
- **Transparency and standard setting:** The EU and China will provide companies from the other party with equal access to their standard-setting bodies. Both sides also agreed to make authorisations more transparent and to enhance legal certainty by agreeing transparency rules for regulatory and administrative measures.
- **Sustainable Development:** The deal will include commitments to not lower labour and environmental protection standards in order to attract investment. Parties have also agreed to effectively implement the Paris Agreement on Climate Change and the ratified International Labour Organization (ILO) Conventions. China has also committed to work towards ratifying the ILO fundamental Conventions on forced labour. The deal will include a mechanism to address disputes related to the implementation of these sustainable development provisions.

- **Dispute settlement:** Parties agreed a two-step mechanism to settle state-to-state disputes based on consultations and, if a solution cannot be reached, recourse via an arbitration panel.
- **Monitoring of implementation:** The deal will include various provisions to monitor implementation of the deal, including regular dialogues, enhanced information sharing between the two parties, and the ability to urgently raise any issues related to implementation. A specific working group to monitor implementation of the provisions on sustainable development will be also established.
- **Investment protection:** Parties have committed to pursue negotiations on investment protection and investor-to-state dispute settlement within two years of signing the CAI.

What is not included in the deal?

However, it is important to note that the CAI focuses on tackling barriers to investment only. It does not cover other trade aspects such as goods, services or digital trade. The deal also does not include provisions around investment protection or a mechanism for investors to raise disputes, although parties have committed to further negotiations in these areas.

In addition, the CAI does not tackle key bilateral issues around overcapacity in steel production, access to public procurement contracts, and trade in counterfeit goods. Some commentators also believe the deal does not go far enough on labour rights, which could affect EU ratification of the agreement.[2] Moreover, it remains to be seen how enforceable certain commitments under the deal are (e.g. around labour standards and state support).

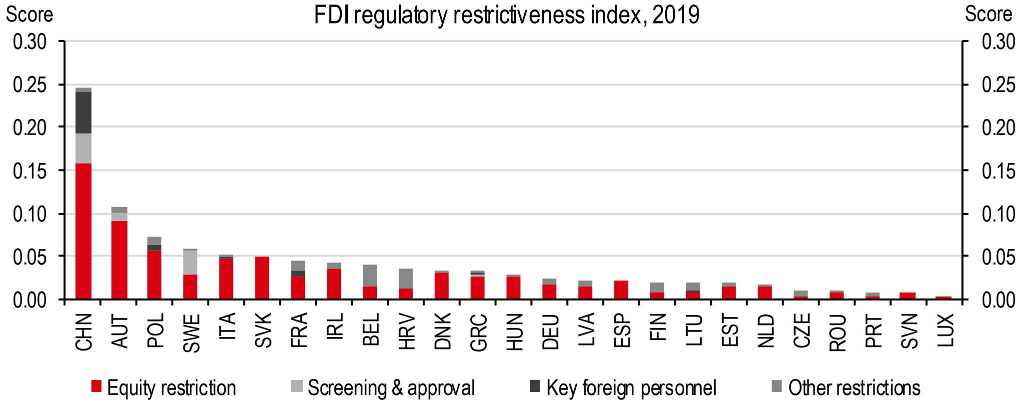
Benefits of the CAI

Overall, the key benefit of the CAI is that it will open up new opportunities for EU and Chinese investors in each other's markets. The deal aims to dismantle barriers to cross-border investment and to provide greater certainty for investors, beyond existing arrangements. For example, all EU member states (excluding Ireland) already have separate bilateral investment treaties (BITs) with China.[3] However, these BITs differ in scope and cover post-investment protection only. They do not tackle market access issues – which is a key element of the CAI.

On balance, EU companies are likely to be the main beneficiaries of the CAI given the EU is already relatively open to Chinese investment (Chart 1). As noted above, China has agreed to new disciplines, for example around subsidies and forced technology transfer, which go beyond existing WTO commitments. However, the specifics of these provisions are yet to be finalised. Non-EU economies may also benefit from Chinese liberalisation in service sectors via the most favoured nation (MFN) provision in the WTO's services agreement (the General Agreement on Trade in Services).

[2] FT, "What is in the EU-China investment treaty?", 31 December 2020.
[3] There are currently 25 BITs between EU member states and China. Ireland does not have a BIT with China and Belgium and Luxembourg agreed a joint agreement.

Chart 1. The EU maintains relatively low barriers to FDI compared to China



Note: The FDI Regulatory Restrictiveness Index measures statutory restrictions on FDI across 22 sectors. It considers the four main types of restrictions on FDI. Scores range from 0 (completely open) to 1 (completely closed).
Source: OECD, HSBC

Although more work needs to be done to finalise the details of the agreement, the CAI represents a strategic win for both parties in our view. EU companies will benefit from expanded access to the Chinese market, while the deal will lock in existing commitments for Chinese companies in the EU. This comes as the EU is looking to tighten rules around unfair foreign competition. The CAI may also provide a platform for parties to liberalise barriers to cross-border investment further, although this is unlikely to expand into other trade areas.

Next steps

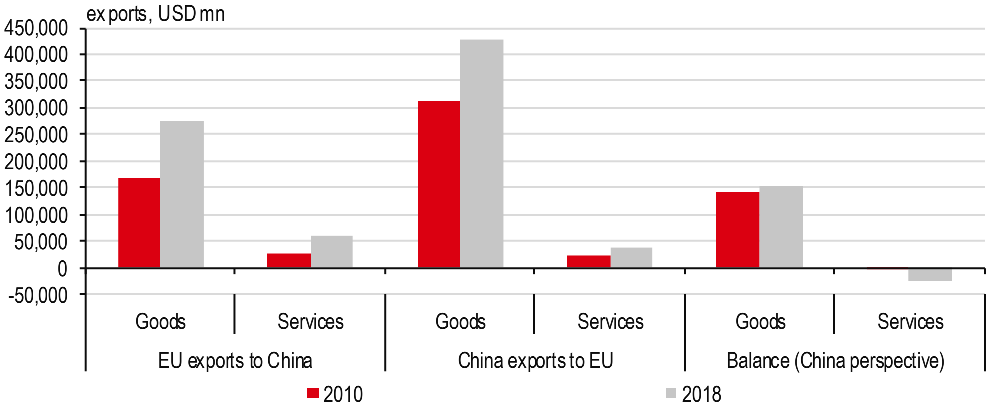
Parties are now working to finalise the text of the agreement, which will then need to be signed and ratified by both sides before taking effect. Parties are aiming to ratify the deal by the end of this year so it can enter into force in early 2022. However, ongoing political issues involving China could affect EU ratification of the deal.

Deeper economic linkages

The CAI comes at an important time as the EU and China have deepened their economic linkages over the years, with notable growth in trade flows. Bilateral trade of goods flows reached USD704bn in 2019, up 26% from USD558bn in 2013 when the discussions were launched (based on EU-28 definition)[4]. The EU is also China's second largest goods export market, accounting for 15.2% of total goods exports (based on 2020 data, EU-27). Chinese imports of goods from EU have also increased notably, more than doubling in the last 10 years, reaching USD276bn in 2019 (based on EU-28). Additionally, the EU is an important source of technology and advanced machinery for China, with machinery and equipment accounting for roughly 30% of total imports from the EU (based on EU-27).

[4] Note: With the departure of the UK from the EU on 31 January 2020, this will impact EU aggregate values. Throughout this report, historical data prior to 31 January 2020, generally refers to EU-28 as it was the legal definition of the EU. However, for ratios, we aimed to use EU-27 data, which excludes the UK where possible to give a forward looking snapshot. FDI data is based on EU-27 as it is a stock value, except for the industry breakdown where only the EU-28 aggregate is available.

Chart 2. Goods and services flows between the EU and China have increased



Source: CEIC, Eurostat, HSBC; Services data only has EU-28 data available historically. Goods has been kept as EU-28 to keep the data comparable.

Services trade[5] has increased as well, with China being the third largest export market as well as import market for EU services, just after the US and Switzerland. Services exports from the EU to China have increased by 88% since discussions were launched, due in large part to growth in charges for intellectual property, travel, transport and ICT services. Services exports from China to the EU are relatively smaller, reaching only 61% of the level of EU exports to China, and have increased by 52% since discussions were launched. Increases in transport, R&D, consulting and travel contributed the most to services exports from China to the EU during this period.

The deeper economic linkages have also been reflected in the currency with the euro taking on a larger share of the currency basket based on the CFETS RMB index, reaching a similar weight to the USD, with the EUR weight at 18.15% compared to the USD at 18.79%.

While trade flows have deepened, investment flows have paled in comparison. Cumulative bilateral direct investment does not even amount to half of a year's amount of the flow of goods trade. Part of the reason for more limited investment stems from longstanding issues of market access which the CAI aims to address. Currently, FDI from the EU into China only accounts for 1.1% of all EU outbound investment, and reached a cumulative USD207bn in 2018 (based on EU-27). Meanwhile, FDI from China into the EU is also small, reaching only 3.5% of total China outbound investment and a cumulative total of USD76.8bn in 2019 (based on EU-27).

By sector, EU FDI into China is concentrated in manufacturing, with automobile investment accounting for 28% of total investment[6]. Part of this has stemmed from both increased demand as China's middle class becomes wealthier, but also likely due to loosening of restrictions to allow foreign firms to wholly own automotive companies in China starting with NEVs (new energy vehicles) since 2018. Chinese firms looking to invest in the EU have also faced hiccups as M&A deals have been denied by European regulators on the grounds of security concerns such as Aixtron in 2016 (FT, 26 October 2016). In all, investment flows between the EU and China have substantial room to grow, and the CAI should help to smooth some these concerns by providing more clear guidelines, increasing market access and encouraging increased transparency.

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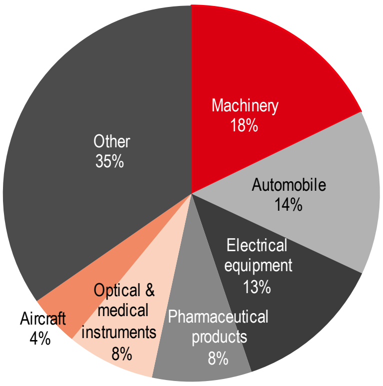
[5] Services data is based on EU-28 as EU-27 data is not available.

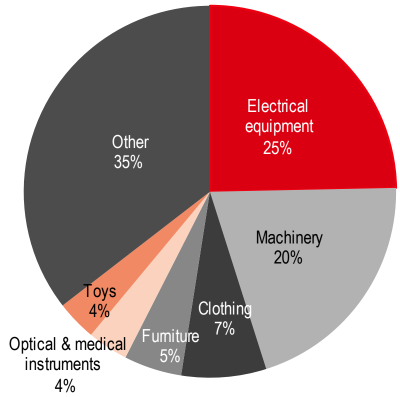
[6] As China's ODI by industry does not separately break out UK data, EU-28 is used.

Chart 3. EU goods exports to China



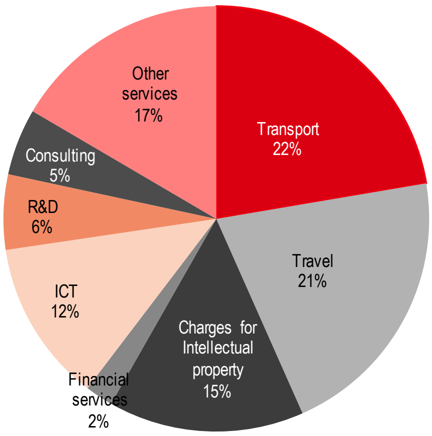
Source: ITC; HSBC; 2019 data; EU-27

Chart 4. Chinese goods exports to the EU



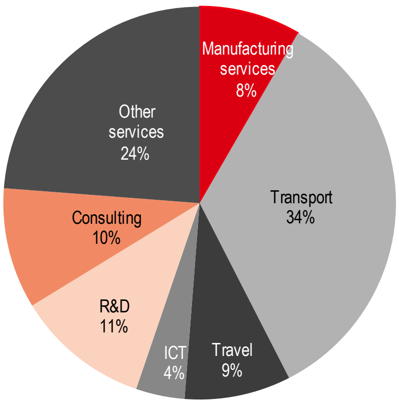
Source: ITC; HSBC; 2019 data; EU-27

Chart 5. EU services exports to China



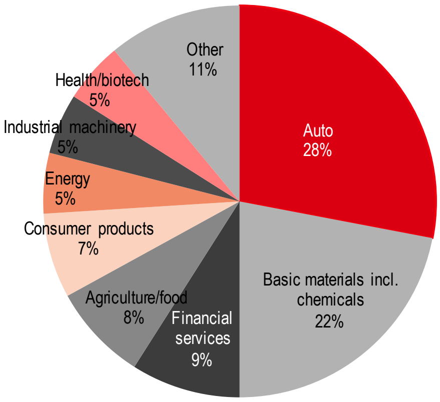
Source: Eurostat, HSBC; 2018 data; EU-28

Chart 6. Chinese services exports to the EU



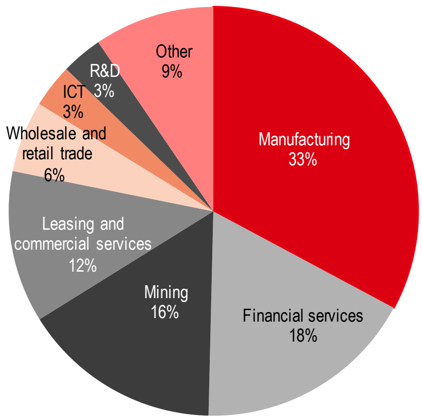
Source: Eurostat, HSBC; 2018 data; EU-28

Chart 7. EU investment in China by industry



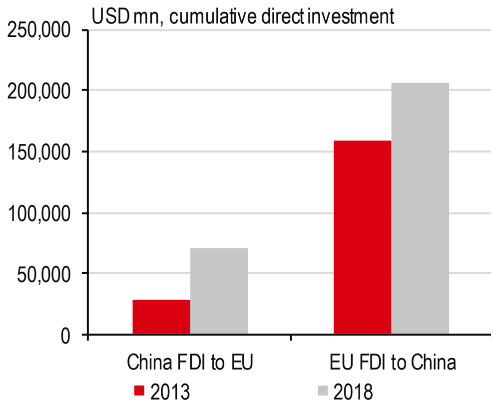
Source: European Commission, HSBC; EU-27

Chart 8. Chinese investment in the EU by industry



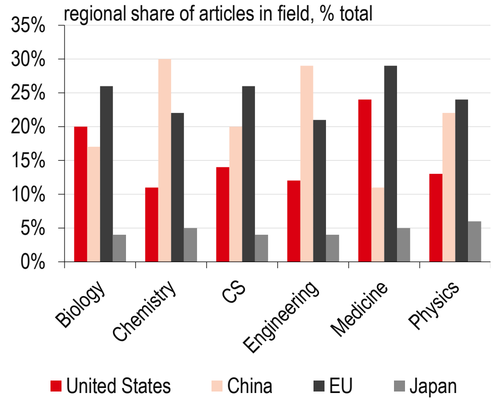
Source: CEIC, HSBC; 2019 data; EU-28

Chart 9. Foreign direct investment between EU and China



Source: CEIC, HSBC, EU-27 with China FDI calculated by subtracting UK from EU historical total

Chart 10. China lags behind the EU in a number of science and technology fields



Source: NSF, HSBC, 2017 data; CS – Computer science

Implications of the deal

Economic impact for China

Firstly, as the deal is yet to be ratified, the near term direct impact will be limited. Additionally, the deal does not lower tariffs as is typical in a free trade agreement, meaning the near term direct impact on trade is also more muted. That said, the increased optimism surrounding the deal as well as improved market access, particularly for services areas, will likely help to provide a small boost for trade flows in the near term. We do not expect a marked shift in the trade balance anytime soon, with China likely to maintain its goods surplus and services deficit with the EU.

In the medium- to longer term, there will likely be more significant gains for economic growth for China as a result of increased investment flows and the likely subsequent flows of people, knowledge and technology. As there are significant technology gaps between China and the EU (Chart 10), upgrading standards and guidelines to help attract more high quality investment into China could help lead to technology gains through both direct and spillover effects. This would help to increase productivity growth and hence potential growth for the longer run. Moreover, as China imports a significant amount of advanced machinery from Europe, with machinery and equipment accounting for 30% of total imports from the EU, improved relations between the two regions would help boost technology gains through goods flows as well.

The signing of the deal should prompt China to accelerate opening and reform measures. This aligns with China's 14th Five Year Plan which aims to complement deeper engagement with the world to support longer term economic growth. China plans to prioritise strengthening intellectual property rights such as through tougher penalties as a deterrent and more streamlined processes for filing infringement cases. Stronger protections will not only help to incentivise more investment from the EU, but also other regions to invest in R&D in China as well as incentivise more domestic innovation.

China has continued to open up its markets to the world and has reduced the number of sectors that are off limits to foreign investors (i.e. the so called "negative list") to 33 from 40 in 2020. The recent gradual opening up of financial services (e.g. insurance, trusts, securities) to allow for full foreign ownership will be maintained. The CAI will give preference for the EU in lifting investment restrictions for some remaining fields such as business services, cloud services, private hospitals, biological resources, and may act as a precursor for broader opening up for other countries. This should help to increase the competition and standards of these industries, which can help to propel growth and innovation of these sectors.

China also plans to implement more structural reform to level the playing field between SOEs and EU firms, but this should also help benefit private domestic firms as well. Reforms would include policies to ensure fair purchases and sales by SOEs as well as increasing mixed ownership reform and fairer access to credit. As SOEs are a less efficient user of resources, levelling the playing field would help invigorate the private sector by helping to redistribute resources to them.

Chart 11. The private sector is more efficient and carries a lower debt burden

Source: CEIC, BIS, HSBC

Commitments to ratify and follow the core ILO principles could help to provide more labour protections and help improve labour quality in the longer run. This would help boost human capital thereby benefiting China's productivity growth. Focus on sustainable development goals to uphold environmental protection standards will also be in alignment with China's longer term target towards more green development and achieving carbon neutrality by 2060. However, as noted above, it remains to be seen how enforceable these provisions are.

Impact on other economies

The CAI may also have implications for investors from other economies. Once the CAI is implemented, foreign investors may find themselves at a competitive disadvantage relative to EU companies when investing in China. For example, the recently concluded RCEP deal, which is anchored by China and comprises 15 Asia-Pacific economies, does not include provisions on subsidies, SOEs, or around protection of labour and environmental standards.

There is also a risk that the new EU-China deal could affect relations between the EU and the incoming Biden administration, which is looking to cooperate with the EU in order to tackle trade grievances with China in a coordinated manner. However, EU Trade Commissioner Valdis Dombrovskis recently noted (FT, 31 December 2020) that the EU still wants to work closely with the US, and that the CAI will simply enable EU companies to attain a comparable level of access to the Chinese market as enjoyed by US businesses under the US-China Phase One deal.

> **"We want to engage very closely with the US. I am not seeing the Phase 1 deal or our comprehensive agreement on investment as hindering this cooperation in any way.**
>
> **EU Trade Commissioner Valdis Dombrovskis in FT, *What is in the EU-China investment treaty?*, 31 December 2020.**

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