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Rocky Road to a Level Playing Field in EU–China Investment and Trade Relations

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At the beginning of 2014, the European Union and China launched negotiations on a bilateral investment treaty that would launch the next stage in economic relations between them. Although both approach numerous issues differently, they have also strong incentives to seek compromise. Reaching an agreement on investment topics could be a significant step towards creating a favourable environment for cooperation and resolving most contentious sticking points in bilateral relations in the near future. It could also become a template for future similar EU agreements.

The European Union has been striving for a level playing field in economic relations with China for a long time. European companies trade with and invest in China more and more extensively, but too often they complain about various difficulties they experience on the Chinese market. For many years, in spite of a declared wish by officials of both sides to sign a new framework agreement that would streamline bilateral relations, efforts to do so were unsuccessful. New hope emerged with the decision to open negotiations on a bilateral investment treaty (BIT), which could pave the way to a more ambitious deal on a free trade agreement, as was pointed out during President Xi Jinping's first visit to Brussels in late March 2014.[1] For the EU, it would be the first stand-alone BIT, and would replace the existing 25 BITs between individual Member States and China.[2] However, negotiations may not be easy if market access is negotiated in addition to investment protection.

A BIT with China: Test for a Common EU Investment Policy

The Lisbon Treaty provided the European Union with the exclusive competence in the area of foreign direct investment (FDI). It assumed that all new investment treaties would be negotiated not by Member States, but by the European Commission. So far, individual Member States are party to approximately 1,700 bilateral investment treaties (overall, there were 2,857 BITs globally by the end of 2012).[3] However, those agreements differ in content, as some of them are decades old[4] and do not contain clauses typical for modern BITs. For example, standard BITs guarantee "post-entry" investment treatment, but do not refer

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[1] "Deepening the EU–China Comprehensive Strategic Partnership," Joint Statement, Brussels, 31 March 2014, http://europa.eu/rapid/press-release_STATEMENT-14-89_en.htm.
[2] Croatia and Ireland have no BIT with China. Belgium and Luxembourg have a joint BIT with China.
[3] UNCTAD, *World Investment Report 2013. Global Value Chains: Investment and Trade for Development*, United Nations, New York–Geneva, 2013, pp. 230–233.
[4] The first BIT was signed between Germany and Pakistan in 1959.

to conditions of entry into a third country market. Furthermore, BITs concluded by individual Member States provide different types of investment protection for European companies, depending on their country of origin and the specific BITs signed by each government, leading to an uneven playing field. The EU wanted to integrate existing BITs concluded by Member States and negotiate future BITs at the level of the union in order to enlarge, better define, and ensure protection of European companies' interests abroad. On the other hand it also wanted to promote the EU as a single market, where common rules, including those related to investment, are applicable in all Member States.

China was indicated as one of the prospective partners for a bilateral investment treaty in 2010, in the EC communication *Towards a Comprehensive European International Investment Policy*. It seemed the obvious candidate to start such negotiations given the scope of EU-China economic relations and high proportion of greenfield investment by European companies on the Chinese market (see data below). The EU indicated that the BIT it wanted to sign with China should cover all operations accompanying investment, including payments, transfer of profits, and protection of intangible assets such as intellectual property. But, in describing the general framework of future BITs to be negotiated, the EU also assumed that investment agreements should be consistent with the other policies of the EU, including policies on the protection of the environment, health and safety at work, consumer protection, cultural diversity, development policy and competition policy.[5] The inclusion of such aspects intuitively could pose a special challenge in negotiations with China.

A BIT as a Way to Enhance Strategic Partnership

Last year marked the tenth anniversary of the EU–China strategic partnership. Since 2003 the EU and China have expanded cooperation in multiple areas. The political relationship has been enhanced and it now encompasses various aspects of foreign affairs, international security and global challenges such as financial crisis, reform of global governance and climate change. The EU and China hold regular high level meetings, including annual High-Level Economic and Trade Dialogue and Strategic Dialogue summits. Furthermore, they have established a large number of sectoral dialogues covering almost all aspects of bilateral relations.

Economic relations comprise the main aspect that binds both sides. Trade exchanges between the EU and China expanded dramatically in recent years, as the EU became China's number one trade partner and China became number two (after the U.S.) for the EU. Total trade flows reached €433.7 billion in 2012, although the value of EU imports from China is twice that of the value of its exports to China. But investment flows show untapped potential. By the end of 2012, EU companies had invested €118 billion in China, while the Chinese FDI into the EU amounted to €26.8 billion. Yet China accounts for just 2.3% of the EU-27 FDI outward stocks, while Chinese investments in the EU accounted only for 0.7 % of the EU FDI inward stock.[6]

A bilateral investment agreement is perceived as a factor that could stimulate bilateral investment flows. The idea of such an agreement emerged shortly after the publication of the EC communication *Towards a comprehensive European international investment policy*, in March 2010. European Commission president José Manuel Barroso and PRC prime minister Wen Jiabao agreed to look into the possibilities of reinforcing conditions for investment both in China and in the EU, at a meeting in Beijing in April 2010.[7] Following that meeting, the Joint EU–China Investment Task Force was set up to explore the scope for deeper cooperation on investment, including considerations of a possible investment agreement. Part of the process in preparation for the negotiations were public consultations held by the EU in 2011, in which European stakeholders expressed their opinions, concerns and expectations regarding a future investment

[5] European Commission, *Towards a Comprehensive European International Investment Policy*, Brussels, COM (2010) 343, p. 7.
[6] Eurostat database, www.eurostat.ec.europa.eu.
[7] Press statement by president Barroso following the executive-to-executive meeting with Chinese premier Wen Jiabao, Beijing, 29 April 2010, http://europa.eu/rapid/press-release_SPEECH-10-197_en.htm?locale=en.

agreement with China.[8] The intention to launch negotiations was expressed during the EU–China summit in February 2012,[9] but talks only began in November 2013, as part of the bold strategic agenda of cooperation adopted at the annual summit.[10] The first round of negotiations took place in January and the second one in late March 2014, just before Xi Jinping's visit to Brussels. Both sides planned four rounds of negotiations for 2014.

Following the settlement of a high profile trade dispute on solar panels last year, which had overshadowed other aspects of cooperation,[11] a BIT should be the major topic in bilateral relations in the near future. When concluded, it could prove that a strategic partnership is filled with more binding and effective content than the dialogue both sides conduct presently.

What Drives Both the EU and China towards a BIT?

Negotiations about a BIT seem to be the most ambitious kind of agreement that the EU and China are ready to undertake presently. Since signing the strategic partnership, the EU and China have not been able to sign any significant economic agreement that would regulate the bilateral economic relationship in the 21st century and replace the outdated Economic and Trade Partnership Agreement of 1985. Talks on the ambitious Partnership and Cooperation Agreement (PCA), which began in 2007 and were assumed to cover not only the economic but also the political dimension of bilateral relations, stalled a long time ago, with no real prospect of conclusion. Despite hints by Chinese officials about the free trade agreement (FTA), even during the recent visit of Xi Jinping to Brussels, serious talk about an FTA between the EU and China was premature, as the EU has a lot of concerns related to Chinese trade policy, treats it as a non-market economy, and has little hope that China would be ready to open its market to the level typical for the kind of ambitious FTAs the EU has already signed (i.e., the EU–South Korea FTA) or is now expecting to reach. However, even in such circumstances, the EU is going to pursue an ambitious BIT which, as stated on several occasions by EU trade commissioner Karel de Gucht, would not only entail investment protection, but also market access.

The investment agreement with China is going to regulate part of the economic relations with one of the EU's major partners. The negotiations with China fit the general picture of the present day foreign economic policy of the European Union. It is now negotiating trade and investment agreements with other important partners. These include the Transatlantic Trade and Investment Agreement (TTIP) with the United States, the FTA with Japan, the Comprehensive Economic and Trade Agreement (CETA) with Canada, and several preferential agreements with other countries. Although these agreements are going to include investment sections, which are not the easiest for negotiators, the BIT with China is the first stand-alone investment treaty negotiated by the EU with any country. It could set the standard for replacing numerous BITs signed by individual Member States in future investment treaties to be negotiated by the EU. But, more importantly, the agreement could allow the EU to position itself better on the Chinese market, broaden access to that market, and reduce potential sources of tension that have recently appeared quite often in the EU–China relationship.

For China, negotiations are going to be a difficult but necessary process. It is aware of the recent shift of major economic powers towards preferential trade and investment agreements, with acceleration of new initiatives in that respect. China is especially concerned with two major trade pacts (TTIP and TPP, the Transpacific Partnership Agreement) currently under negotiation. As it is not part of either of those two agreements, or of other FTA initiatives of the EU and the U.S. in Asia, China feels surrounded by trade pacts in its neighbourhood. Furthermore, Beijing cannot be passive when it is expected that major new trade and investment agreements could set the standards that might be applicable to FTAs that any country, even China, negotiates in the future. But for China, which, after the global financial crisis, became

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[8] See the results of the consultations in the report: *Summary of Contributions to the European Commission's Public Consultation on "The future Investment Relationship between the EU and China,"* www.trade.ec.europa.eu.

[9] *Joint Press Communiqué of the 14th EU–China Summit*, Beijing, 12 February 2012, www.eeas.europa.eu.

[10] *EU–China 2020 Strategic Agenda for Cooperation*, Beijing, 21 November 2013, www.eeas.europa.eu.

[11] See: *European Foreign Policy Scorecard 2014*, The European Council on Foreign Relations, 2014, p. 29.

one of the main sources of FDI, it is no less important to secure better conditions of access for Chinese investors to the most important markets. To address such a challenge, China concluded BITs with Canada, South Korea and Japan in 2012, and has signed 149 bilateral investment agreements in total,[12] but negotiations with the United States that started in 2008 have not yet been finalised. In the case of the EU, penetration of the market by Chinese investors has been rising, especially through the merger and acquisition of high-tech European companies. But a lack of modern BITs could pose a barrier to further expansion in those countries which, through investment, China can gain access to advanced technology and know-how and where Chinese companies can expect to upgrade their technological capabilities.

Concerns to Be Addressed through a BIT

Through a BIT with China, the EU wants to achieve a level playing field for present and future European investors. While the EU is generally open for FDI, and foreign investors can feel safe operating on the transparent and predictable European market, there are several concerns related to China's FDI policy. European companies expect that a BIT with China will address these concerns, improve predictability and transparency related to business activities, and contribute to opening up the Chinese market for new investment opportunities.

First, a BIT should influence the improvement in clarity of regulations regarding foreign investors' operations in China. European companies complain of opaque regulations, often only published in Chinese, different standards, and inconsistent implementation of laws at national, provincial and municipal level, as well as continuous modification of regulations with immediate effect. Licensing requirements and complicated procedures constitute a serious barrier for foreign investors wishing to enter the Chinese market.[13]

Second, the agreement should address the concern of discriminatory treatment of foreign investors. Preferential treatment for domestic companies is revealed in foreign ownership limitation, joint venture requirements and some tax benefits. A discriminatory approach towards foreign companies appears in investment procedures that are more complex and take longer if the company does not have a local partner. Another aspect concerns the advantages enjoyed by Chinese state owned enterprises (SOEs) that benefit from state subsidies and are often favoured in public procurement processes, distorting fair competition and creating an uneven playing field, both in regard to foreign and domestic companies in China, and in the context of investments by SOEs or subsidised companies from China in the EU.

Third, a BIT should ensure that there would not be a mandatory foreign technology transfer rule when European companies plan to invest in China. Such practice is used very often as way gain access to advanced technology and know-how from foreign companies. For example, Chinese officials normally force multinational companies to form joint ventures with its local companies, and transfer the latest technology in exchange for business opportunities. Although the WTO prohibits mandatory technology transfers, the Chinese government maintains the system of incentivised transfers, whereby companies trade technology for market access. The process also takes the form of compulsory licensing of technology.[14]

Fourth, a BIT should seek the highest possible level of standards of legal protection, as many European companies have little confidence that their rights as investors are protected sufficiently in China. They complain that the Chinese legal system lacks transparency and consistency, both in the decisions and in the judicial process itself, and regarding the gap between the written law and its application and enforcement. Many European companies now prefer to settle any conflict in an amicable way through consultation, as they fear that starting legal proceedings, including international arbitration, would prevent them from doing

[12] UNCTAD International Investment Agreement Database, www.unctad.org.

[13] *Summary of Contributions to the European Commission's Public Consultation on "The Future Investment Relationship between the EU and China,"* Directorate General for Trade, European Commission, Brussels, 2011, pp. 6–7.

[14] *Technology Transfer to China: Guidance for Businesses*, China IPR SME Help Desk, www.china-iprhelpdesk.eu.

business again in China, or that it would impact their daily operations in China.[15] Hence, the agreement with China should ensure the enforcement of any agreed rules through an adequate dispute settlement system. There is a preliminary consent that both investor-state (ISDS) and state to state dispute settlement (SSDS) should be part of the agreement. But even in the EU negotiation with the U.S. on investment part of TTIP, the question of ISDS emerged as one of the most contentious and became for the subject of additional public consultation. Any solutions to be adopted within TTIP are going to have an impact on the provisions to be adopted in the EU–China BIT.

Fifth, BIT should provide EU investors with better market access. Negotiations on this aspect need to address the question of the barrier in FDI inflow regulated through the *Catalogue for the Guidance of Foreign Investment Industries*.[16] According to the most recent document, China divides sectors for investment into three categories, those that are encouraged, those that are restricted and those that are prohibited. Requirements for investors depend on the category in which their specific industry or sector falls. Restricted activities often require extensive regulatory authorisation, and investment may be limited to a joint venture. For example, projects valued at $300 million or more for encouraged sectors ($50 million for restricted industries) must be verified by the National Development and Reform Commission (NDRC) or other relevant agencies (for example, industry regulators) at the national level, and projects below these thresholds are verified and approved by local DRCs.[17] Based on the decisions made at the Third Party Plenum in November 2013, which assumed "more market, less state" principle in the planned economic reforms in China,[18] there is an opportunity for more openness in the Chinese market for foreign investors. In this context there are expectations of changes in the current Chinese investment policy regime. One EU aim in BIT negotiations with China should be a "negative list" of sectors with restrictions for foreign investors that is as short as possible.

Outstanding Issues in Market Access

The EU is striving to link ongoing BIT negotiations with a higher level of market access to China for European companies. Although, there is little chance that several highly important issues from the EU point of view will be agreed upon during talks, ongoing negotiations represent an opportunity to touch upon such topics, discuss both parties' stances, and prepare the ground for the next steps in regulating EU–China economic relations. This might be achieved in the future framework of an FTA, carefully mentioned by both sides, which could be a subsequent step in tightening EU-China economic ties. However, discussing an FTA would be more probable if BIT negotiations are successful.

One can identify some contentious issues that, given the parties' divergent attitudes, will probably not be included in a BIT, and thus further hinder the development of the EU–China relationship.

Better access to the public procurement market in China has been one of the most articulated issues by the EU. According to the European Union Chamber of Commerce in China (EUCCC), China's public procurement market could have been worth RMB 10.4 billion ($1.7 billion) in 2011 (about 20% of China's GDP).[19] The EU wants to ensure fair competition and equal access to the Chinese market, just as its own public procurement system is open to foreign bidders. However, there are still lots of obstacles to foreign companies operating in this market. Public procurement law is widely perceived as tangled and inconsistent, though it consists of two main documents, the Government Procurement Law (GPL) and the Tender and Bidding Law (TBL). Unclear provisions create misunderstandings and difficulties for potential investors. Furthermore, not only is it hard to find accurate information on public tenders in the first place, but

[15] *Summary of Contributions to the European Commission's Public Consultation on "The Future Investment Relationship between the EU and China," op. cit.*, p. 10.
[16] *Invest in China*, MOFCOM, Beijing, 2013, pp. 33–62, www.img.project.fdi.gov.cn.
[17] WTO, *Trade Policy Review: China*, Geneva, 2012, p. 21.
[18] J. Szczudlik-Tatar, "China's New Reform Roadmap: Cautious but Significant Changes," *PISM Bulletin*, no. 131 (584), 29 November 2013.
[19] *European Business in China*, Position Paper 2013/14, European Union Chamber of Commerce in China, Beijing, 2013, p. 75, www.europeanchamber.com.cn/en/publications-position-paper.

companies often face lack of transparency regarding public procurement criteria as well as the evaluation of tenders. There are also significant hurdles regarding appeal procedures, which are complex and often time consuming.[20] The requirement to choose "domestic goods and services" along with lack of official definition of this term may also cause considerable problems.

An uneven playing field in market access is also visible in several industries. If a foreign company wants to invest in the manufacturing sector, it needs to apply for permission to the proper authority. Moreover, some industries are also additionally protected. Restrictions may take various forms, such as the requirement that the majority of shares must be held by Chinese partner. Lack of alignment is clearly visible in, for example, the automotive industry. Chinese entities are allowed to invest or make acquisitions in the EU market without serious restrictions. This was reflected, for example, when the Chinese company Geely bought Swedish Volvo in 2010. Such a deal could not be conducted on the Chinese market while local law requires foreign investors to create joint ventures, limited to a maximum 50% share, in order to operate in China.[21] Similar requirements exist in numerous other sectors, such as food processing or pharmaceuticals. Another limitation is the determination of the legal form of the company to equity or contractual joint ventures. This is common in some industries, such as construction machine production.

There is also a visible asymmetry regarding the possibilities of acquisition in the energy sector. Chinese companies are allowed to take control of European firms, which was demonstrated by China's State Grid Corporation purchase of a 25% stake in Redes Energéticas Nacionais (REN), the Portuguese national energy network, in 2012. A similar situation regarding a Chinese operator seems to be improbable given regulations in the energy sector. A legal framework is also needed in other spheres connected with energy, such as shale gas exploration conditions for foreign investors. There are more sectors in which genuine competition is highly limited or even do not exist. Among those areas are, for example, railroad transportation, education, healthcare, news and publishing. As demand grows, state control in some sectors could be relaxed, especially in the case of services such as education or healthcare.

There are significant opportunities in many areas of the service sector, though they are little utilised. The EU has an especially great interest in Chinese financial services. Banking, non-banking financial institutions and insurance companies are perceived as among those sectors most isolated from foreign investment. Numerous restrictions and regulatory measures prohibit foreign companies from expanding their share in local financial market. Currently, foreign investor ownership level in domestic banks is fixed at 20% for a single foreign investor, with a cap of 25% on overall foreign ownership.[22] The EU institutions have called for Chinese authorities to ease provisions concerning obtaining licences for banking or insurance activities, and to lift the three-year waiting period after which banks are eligible to submit an application for an RMB licence.[23] A difficulty is also posed by the existing complex system of submissions to expand foreign financial institutions at the branch and sub-branch network level, as well as restrictions regarding foreign exchange payments. Moreover, the China Banking Regulatory Commission (CBRC) has to approve all of the senior bank officers, which makes human resources management more complicated. Yet some facilitations regarding access to the financial market were made in 2012–2013, including foreign investors' ability to hold up to 49% of shares in securities joint ventures, and approval for the first five foreign banks to trade Chinese stock-index futures.[24] Business opportunities could be seized by European companies in other prospective areas, such as legal or logistics services. Establishment of the Shanghai Pilot Free Trade Zone in 2013, where trade in several categories of services would be liberalised, is a positive sign of the Chinese authorities' willingness to enhance cooperation in this sphere.

A permanently outstanding issue that is a serious barrier for European companies on the Chinese market, and is yet to be addressed more seriously, is intellectual property rights (IPR). Numerous European

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[20] *European Business Experiences Competing for Public Contracts in China*, European Union Chamber of Commerce in China, Beijing, 2011, pp. 32–35, www.europeanchamber.com.cn/en/publications-public-procurement-study-european-business-experiences-competing-for-public-contracts-in-china).

[21] *European Business in China*, *op. cit.*, p. 106.

[22] *Ibidem*, p. 328.

[23] *Ibidem*, p. 330.

[24] *Ibidem*, p. 326.

companies are affected by counterfeiting and piracy, which cause serious financial losses. The scale of IPR infringement in China is significant—according to 2011 data more than 70% of goods suspected of infringing IPR worldwide came from China.[25] To mitigate this problem, EU–China Dialogue on revamping the IPR protection system has been pursued since 2004. Moreover, in 2010, the Chinese authorities issued an IPR Protection Action Plan. Recently, there have been some noticeable propositions aimed at strengthening IPR protection regarding, for example, trademark and copyright law. Nevertheless, a couple of areas in which reforms are badly needed can be pointed out, in particular, the official recognition of "well-known trademarks" which allows broad protection against infringers to be obtained. Foreign firms are often clearly discriminated against in registration procedure in comparison to Chinese ones—every year only 1% of trademarks recognised by the State Administration for Industry and Commerce (SAIC) belong to non-Chinese companies. Also, dispute settlement procedures regarding trademarks should be adjusted to international standards. Moreover, the EU is calling for a revamp of the regulations concerning patent registration, as well as Original Equipment Manufacturing (OEM), which allows non-trademark goods to be exported from China.[26] Enhanced cooperation on strengthening Geographical Indications (GI) protection should also be taken into account in the future.

Conclusions

A bilateral investment agreement with China provides an opportunity to address concerns that the European Union has voiced for many years. China became the major economic partner for the EU, but it felt that there was an uneven playing field in terms of openness and barriers for companies operating in each other's markets. While the EU has transparent and predictable conditions and treats domestic and foreign companies on an equal footing, European companies face several barriers when they try to invest or are present on the Chinese market. The EU hopes a BIT with China will improve not only the level of investment protection for those companies doing business in China, but will also reduce the barriers for entry. Hence, the priority for the EU in negotiation on a BIT should be improvement in clarity of regulations for foreign companies operating in China, ensuring equal treatment of foreign investors and domestic companies, the highest possible level of standards of legal protection and dispute settlement, and addressing the problem of mandatory technology transfer. Furthermore, the market access part of the future agreement should contribute to wider opening of sectors (such as telecommunication, financial services, and some manufacturing industry sub-sectors) where there are some limitations in terms of equity shares for foreign companies. Negotiations on such an ambitious BIT are not going to be easy, but both sides strive to achieve such an agreement not only to enhance the EU–China strategic partnership and implement the 2020 agenda for cooperation agreed in November 2013, but also to better regulate and liberalise economic relations at a time when major economies are pursuing preferential trade and investment treaties all over the world.

Signing a bilateral investment agreement should incentivise investment by European companies from countries with less experience on the Chinese market (for example, those in Central Europe), as well as by small and medium-sized companies from all EU Member States. Those companies face the same barriers when they want to invest or operate in China, as do companies from Western Europe. In the case of Polish companies, the most problematic issues are requirements for technology transfer, high initial costs of establishing cooperation with China, burdensome procedures, and non-transparent regulations. In addition, almost 40% of these Polish companies have conflict situations in cooperation with Chinese partners.[27] But, in the case of firms from Central Europe, overcoming such barriers can be more burdensome as they may have less experience and capabilities to deal with problems there. Furthermore, an EU–China BIT is going to provide better investment protection as many countries from the region have outdated BITs (Poland

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[25] European Commission, *Report on EU Custom Enforcement of Intellectual Property Rights: Results at the EU Border*, Brussels, 2011, p. 3, http://ec.europa.eu/taxation_customs/resources/documents/customs/customs_controls/counterfeit_piracy/statistics/2012_ipr_statistics_en.pdf.
[26] *Ibidem*, pp. 50–57.
[27] *China–Poland: Assessment of Polish Enterprises' Cooperation with China*, PISM and KPMG Report, Warsaw, September 2013, pp. 35–39.

signed a BIT with China in 1988) with provisions that refer only to expropriation or nationalisation, but lack important provisions guaranteeing procedural protection of foreign investment, equal treatment and modern dispute settlement. Such an agreement could play an important role in a time when more and more Polish companies are looking for new, attractive markets for expansion and investment diversification, among which China should be an obvious choice.