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Chinese Direct Investment in Europe – Challenges for EU FDI Policy

Chinese foreign direct investment (FDI) into the European Union (EU) has increased substantially over the last decade. Whereas the EU generally welcomes inward FDI, FDI from China has been often accompanied by concerns. In view of these developments, the EU now faces the challenge of reforming its FDI policy in such a way as to simultaneously (i) defend the EU's current openness to FDI (including from China); (ii) address the security concerns that have been raised for some types of FDI; and (iii) ensure greater openness and a level playing field for European FDI in China. Two EU policy initiatives are particularly important here: the establishment of an EU-wide framework for screening inward FDI on grounds of national security and public order and the negotiation of a bilateral investment agreement with China. In the following we discuss the motivation, development and prospects of these initiatives.

DEVELOPMENT OF CHINESE FDI IN EUROPE

Direct investment from China into the EU has increased sharply since 2010, and since 2013 in particular (Figure 1). According to transaction-based data compiled by the Rhodium Group,[1] the value of Chinese FDI flows into the EU was about 29.7 billion euros in 2017, which was slightly lower than the peak in 2016 (35.9 billion euros), but almost fifteen times the value in 2010 (2.1 billion euro).[2] The data also show that the vast majority of these investments were mergers and acquisitions, whereas greenfield projects have only accounted for around five percent of total direct investment in recent years. Geographically, Chinese FDI into the EU has generally focused on the economically more advanced EU member states and on France, Germany, Italy and Britain in particular. Sectorally, they have recently concentrated on transport, utilities and infrastructure, ICT and advanced industrial machinery and equipment (Hanemann and Huotari 2018). The key sectors selected for investments are thus broadly in line with the focus of China's current industrial policy.

Compared to the surge of Chinese FDI in Europe, European FDI in China increased only moderately before 2012, and even declined after 2012. They have recently been much lower than Chinese FDI in Europe (see also Figure 1). One of the factors frequently cited as responsible for the comparatively poor development of European FDI in China is the persistence of a large number of restrictions on European companies investing in China.

In fact, according to the OECD FDI regulatory restrictiveness index, China is one of the most restrictive economies with respect to inward FDI.[3] Among the 68 countries covered, only three countries (Indonesia, the Philippines and Saudi Arabia) had a higher Index (i.e. more restrictive FDI policies) than China in 2017. Despite some improvement over the past two decades, the FDI restrictiveness index for China (0.32) is still much higher than the OECD average (0.07). In contrast, almost all EU nations have been consistently among those countries with the lowest levels of FDI restrictiveness. In 2017, most member states had an index value at or below 0.04; and Austria (0.11) was the only member state with an index value above the OECD average.[4]

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CONCERNS OVER AND POLICY DEBATES ABOUT CHINESE FDI

European countries actively promote inward FDI, including FDI from China. At the same time FDI from China has increasingly raised economic, political and national security concerns among European policy makers and the wider public. The fact that these concerns are raised in particular with respect to FDI from China relates to a number of specific features of Chinese FDI[5] and, more importantly, to broader reservations about the nature of China's economic and political system and its growing geopolitical and geoeconomic ambitions (Hanemann and Rosen 2012; Hanemann and Huotari 2015; Meunier forthcoming).[6]

A first economic concern is that Chinese FDI into Europa may lead to a one-sided transfer of modern technology and related economic activities from Europe to China. China is still an emerging economy

[1] We are grateful to Thilo Hanemann of Rhodium Group for providing the data.

[2] For individual years transaction-based FDI data can differ substantially from FDI data from official European and Chinese data sources. For a comparison of different datasets, see Hanemann and Huotari (2017).

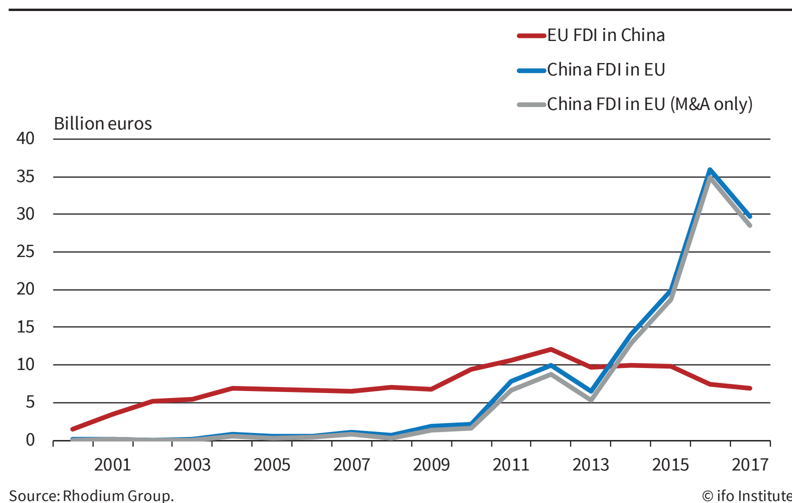
[3] For more on the OECD's FDI regulatory restrictiveness index, see http://www.oecd.org/investment/fdiindex.htm.

[4] Overall, the EU has one of the most open investment regimes in the world. Openness to foreign investments is enshrined in the EU Treaties. Article 63 TFEU prohibits any restriction on capital movements not only between member states but also between member states and third countries.

[5] This includes their novelty and rapid growth, their concentration on sensitive or strategically important sectors, and the low share of greenfield investments, which are often seen as more beneficial and less politically problematic than M&As.

[6] China is the world's second-largest economy giving it enormous leverage to shape the world economy and politics. It is still lagging behind the EU in many areas of technology, but has ambitious policies of promoting technology upgrading including through outward FDI. Its economy is characterised by widespread state influence, ambitious industrial policies, and a multitude of restrictions and discriminations of foreign companies. Politically, China is a one-party authoritarian state with a tenuous record for protecting individual rights and the rule of law. It is also an emerging military superpower with geopolitical ambitions and foreign policy goals that are often at odds with those of European countries.

Figure 1
Bilateral FDI Transaction Values in China and the EU



Source: Rhodium Group. © ifo Institute

lagging behind Europe in many areas of technology and business expertise. At the same time, China is pursuing industrial policies that strongly promote its technological catch-up process including through outward FDI. This may, it is feared, lead to a situation where industrial policy directives trump commercial logic when Chinese acquirers of European companies decide where to deploy the latest technologies of the acquired companies or where to locate their research and development activities (Hanemann and Huotari 2015). As a result, European firms and host countries may not reap the benefits of technological spill-overs usually induced by FDI and, in the long run, Europe might lose its technological edge and economic competitiveness to China.

A second economic concern is that unrestricted FDI by Chinese companies in Europe could exacerbate 'unfair competitive advantages' that politically protected and subsidised Chinese companies have over European companies. China is still restricting FDI in many sectors of its economy and many Chinese companies (not just state-owned enterprises) benefit from government subsidies and multiple other political privileges. Through FDI in Europe, these subsidised firms are now competing head-to-head with European firms on European markets too, thereby, extending their unfair competitive advantages over European firms (Hanemann and Huotari 2015). Foreign acquisitions by subsidised Chinese companies can also lead to distortions in the allocation of capital. This is the case, for instance, when a Chinese company can outbid a European company in acquiring another European company, not because it can use the assets of the target company more efficiently, but because it enjoys political advantages in China (Hanemann and Huotari 2015).

Political concerns over Chinese FDI into the EU relate, in particular, to the fear that China could use the promise to increase; or the threat to withhold or withdraw FDI to pressure host governments to act in line with China's ideas on political issues that are particularly important for the Chinese government (One-China policy, Tibet, human rights in China). In the past, China has repeatedly demonstrated its willingness to use its economic power to exert political pressure on other countries, or to punish them for political decisions that violate China's political interests – with some success.[7]

National security concerns over specific types of inward FDI are not new and are not restricted to FDI from China.[8] There are, however, several reasons why security concerns may be particularly relevant for FDI from China. Unlike most other large source countries of FDI into Europe, China is not a security ally of EU member states. It is a rising superpower with a rapidly modernising army, and with increasing geopolitical ambitions and declared foreign policy goals that are often at odds with those of European countries and their allies in North America and Asia. Security concerns, particularly related to the leakage of militarily sensitive technology, are exacerbated by China's past violations of export control regulations and the transfer of sensitive technologies to regimes such as Iran, North Korea or Pakistan. Apparent cases of Chinese economic and political espionage and cyber penetration reinforce this distrust. As with economic concerns, national security concerns about Chinese FDI are aggravated by the opaque involvement of the Chinese government in these investments, which leaves some doubt as to their ultimate rationale (Meunier forthcoming; Hanemann and Rosen 2012).

FDI SCREENING IN THE EU

With the entry into force of the Lisbon Treaty in December 2009, the EU's exclusive competence over the common commercial policy has been extended to cover FDI too now.[9] This shift of competence has

[7] The political influence that China has gained through direct investment in Europe is already seen by some observers as a serious challenge to the cohesion of EU policy towards China. It has been reported, in particular, that Greece and Hungary have, on different occasions, refused to support joint EU statements on China's human rights policy, or on its territorial claims in the South China Sea.

[8] In general, potential national security threats from foreign ownership fall into three categories: (i) the transfer of (military) sensitive technology; (ii) the denial or manipulation of access to a critical input by a foreign-controlled supplier; and (iii) the infiltration, surveillance or sabotage of production systems crucial for the functioning of economy (e.g. critical infrastructures in energy or transportation, or telecommunications and cyber networks) – see Moran (2017).

[9] Whereas the general competence for FDI now rests with the EU, specific competences relevant for the design and implementation of a European FDI policy continue to reside with the member states (the protection of their national security) or are shared between the EU and its member states (e.g. the competence for portfolio investments and for provisions on investor-state dispute settlement).

substantially strengthened the role of the European Commission in shaping the EU's FDI policy. With regard to Chinese FDI in Europe, the Commission currently focuses on two policy initiatives: (a) establishing a common framework for screening inward FDI on the grounds of security and public order, and (b) the negotiation of a bilateral investment agreement with China.[10]

Currently there is no centralised mechanism to screen FDI on grounds of public order or security at EU level, and there is no formal coordination among member states or between member states and the Commission in this field. At the same time, about half of the EU nations – including the EU's largest economies, Germany, France, Italy and Britain – have some national FDI screening mechanism in place (Grieger 2017).[11] Existing screening mechanisms vary considerably between member states with respect to both their scope (covering only FDI from third countries or also from other member states; covering only specific sectors or all sectors of the economy; screening for threats to essential interests of national security or to public security and public order) and their design (voluntary *versus* mandatory notifications; *ex-ante* authorizations *versus ex-post* approvals of acquisitions).[12]

Several EU countries have tightened their FDI screening mechanisms in recent years, or are currently discussing such changes. Let us consider the example of Germany, were the most recent legislative tightening of FDI screening came into force in July 2017. A central element of the reform was the introduction of a catalogue of industry sectors for the first time, defining critical infrastructure and security-related technologies, where the acquisition of at least 25 percent of the voting rights of a German company by a non-EU/EFTA foreigner is, by law, considered to be a potential threat to public security or public order and must be notified to the Federal Ministry for Economic Affairs (BMWi). While the BMWi still has to decide on a case-by-case basis whether the acquisition *actually* endangers public order or security, it is expected that the amendment will lead to a more thorough examination of future acquisitions. Hardly a year after this reform came into force the BMWi has already announced a further tightening of the regulations. It plans to lower the threshold for investment screening from 25 to 15 percent of the voting rights of the target company.

The German government's increasingly critical attitude towards Chinese FDI is also reflected in the treatment of some recent FDI cases involving Chinese investors. A number of proposed acquisitions of German companies, most notably Kuka and Aixtron, were discussed and observed very critically by the federal government in 2016 and 2017.[13] Then, in August 2018, the German cabinet *for the first* time ever prohibited an acquisition of a German firm on national security grounds. The veto concerned the acquisition of German engineering firm Leifeld Metal Spinning by a French unit of China's Yantai Taihai Group. In 2018, the government also prevented two attempts by the Chinese electricity giant SGCC to acquire a 20-percent stake in 50Hertz, one of Germany's four electricity transmission system operators.[14]

The current changes in FDI screening mechanisms within individual members states are accompanied by a growing number of requests for the establishment of an EU-wide framework for screening inward FDI. Most notably, in 2017, the French, German and Italian governments jointly approached the European Commission with a proposal[15] to create legal conditions that would allow member states to prohibit or condition FDI not only on the grounds of national security and public order, but also on the basis of economic criteria such as a lack of reciprocity in investment conditions between the home country of the investor and the EU, or a lack of market compatibility of the transaction due to state influence (including through subsidies) on the investor.[16]

As a result of the intensified debate, the European Commission presented a proposal for a regulation 'establishing a framework for screening of foreign direct investments into the European Union' in September 2017.[17] The regulation intends to provide legal certainty to member states and to ensure EU-wide coordination and communication, but it does not set out a unified EU-wide FDI screening mechanism. According to the proposal, the EU countries may main-

[10] While the former is not restricted to FDI from China, it is mainly motivated by concerns related to the strong increase of Chinese FDI into the EU.

[11] Some EU member states are unwilling to impose any restrictions on inward FDI in order to be attractive for foreign investors.

[12] Outside the EU, most large advanced economies such as Australia, Canada, Japan and the United States, and major emerging economies such as China and India, have FDI screening mechanisms of varying scope and design (Grieger 2017). The most widely-known and arguably the most sophisticated of these screening regimes too is that of the United States. It has repeatedly been proposed as a potential role model for other economies, including the EU.

[13] In case of Kuka the acquisition was completed after the BMWi gave green light for the transaction, despite its critical stance. The planned takeover of Aixtron was prohibited by the US administration before the BMWi made its final decision. (In the United States the review process applies not only to foreign investment in the United States, but also to foreign investment in foreign companies that have affiliates in the United States. Aixtron had a wholly-owned subsidiary located in California.)

[14] Here the government could not use the official screening mechanism, which only applies to the acquisition of at least 25 percent of a company's voting shares. The government therefore nudged Elia, the Belgian majority owner of 50Hertz to exercise its right of first refusal to buy the 20 percent stake offered by minority shareholder IFM Investors. Elia made use of its right to purchase the shares; the first time to increase its own stake in 50Hertz, and the second time to resell the shares to the German state-owned development bank KfW.

[15] *See European Investment Policy: A Common Approach to Investment Control,* 28 July 2017, http://g8fip1kplyr33r3krz5b97d1.wpengine.netdna-cdn.com/wp-content/uploads/2017/08/170728_Investment-screening_non-paper.pdf.

[16] Similar suggestions were made by other politicians (including a group of members of the European Parliament), representatives of European business in China (European Chamber 2017) or China experts (e.g. Wübbeke *et al*. 2016).

[17] *Proposal for a Regulation of the European Parliament and of the Council Establishing a Framework for Screening of Foreign Direct Investments into the European Union,* COM(2017) 487, European Commission, 13 September 2017, https://eur-lex.europa.eu/resource.html?uri=cellar:cf655d2a-9858-11e7-b92d-01aa75ed71a1.0001.02/DOC_1&format=PDF.

tain, amend or adopt FDI screening mechanisms on the grounds of security or public order, but are not obliged to do so. The proposed regulation features a non-exclusive list of factors that may be taken into consideration in the screening on grounds of security or public order. These factors include the potential effects on critical infrastructure, critical technology, the secure supply of critical inputs, or access to or the ability to control sensitive information. The control of a foreign investor by a foreign government (including through significant funding) could be taken into account in assessing an investment's effects on security or public order. The proposed regulation does not, however, extend the screening grounds to purely economic factors such as reciprocity of investment conditions or market compatibility of the transaction. Member states' screening mechanisms shall not discriminate between different third countries either.

The regulation would introduce a (new) possibility for the Commission itself to screen FDI that are likely to affect projects or programmes of Union interest on the grounds of security or public order.[18] Here the European Commission may address a *non-binding* opinion to the member state in which the investment is planned or completed and which is then responsible for the final decision.[19] To improve the coordination of review decisions taken by EU member states, the regulation would also establish a cooperation mechanism between the EU countries and the Commission to exchange information on cases where a foreign investment planned or completed in one member state is considered likely to affect security or public order in others. In such cases the other member states or the Commission may issue comments or opinions that the member state where the FDI is planned shall duly consider in his decision.

Although the Commission proposal clearly falls short of the common proposal of France, Germany and Italy as regards the reasons for which FDI could be blocked, the governments of the three countries welcomed the proposal. Other member states have, however, expressed scepticism, or even opposition to the proposal (Di Benedetto 2017). Whether, or in which form, the proposed regulation will eventually be adopted thus remains to be seen.

The assessment of any proposal for the introduction of a new FDI screening framework for the EU must be based on the recognition that openness to FDI is an important factor for the success of the European economy. The EU must therefore maintain an investment regime, which is open to investors from the rest of the world, irrespective of the country of origin. At the same time, the EU investment regime should include effective measures to protect the security and public order of the member states and make sure that differences in their attitudes with respect to investments by Chinese SOEs, for example, do not negatively affect other member states' national security. These objectives do not have to be in conflict. On the contrary, the creation of a transparent, effective and well-focused European framework for FDI screening on grounds of national security and public order may even be a prerequisite for defending the EU's current openness against a protectionist backlash and an increasing politicisation of individual FDI transactions.

It must be ensured, however, that reference to national security and public order cannot be misused for protectionist purposes or other purely economic ends. Investment screening in the EU should thus be explicitly limited to plausible threats to national security and public order only; and should *not* be based on arguments of reciprocity, unfair competition or on any kind of industrial policy or economic security considerations. Moreover, it must not discriminate between investors from different non-EU/EFTA countries.

Possible security threats are not limited to foreign acquisitions in the defence industry. It is adequate, therefore, to allow for the screening of individual foreign acquisitions in a wider range of sectors. However, security screening should not preclude acquisitions by investors from certain countries (like China or Russia) for entire sectors. This would not only exclude valuable investments for broad areas of the European economy, but would also legitimise reciprocal sector-wide exclusions of European investments by these (and other) countries (Moran 2017). It would thus undermine the EU's efforts to negotiate better access for EU investments to third countries, in particular China (see also below).

In this context, state ownership or control of a foreign investor may (only) be taken into account in assessing whether a foreign acquisition is likely to affect security or public order. However, state ownership or control in itself does not constitute proof of a plausible threat to security or public order, but may affect the plausibility of such a threat in individual cases. Purely economic implications of state-ownership or privileged access to government subsidies (e.g. market distortions) should not be used as criteria in investment screening.

Similarly, the approval of proposed acquisitions should not be made conditional to equal treatment of European investors in the home country of the acquiring firm. Instead of following a logic of negative reciprocity, the EU should step up its efforts to achieve greater openness and equal treatment of European firms on foreign, and particularly in Chinese markets through bilateral or multilateral trade and investment negotiations (positive reciprocity).

Industrial policy or 'economic security' considerations should not be legitimate causes in investment screening. This particularly applies to potential technology transfers resulting from the acquisition of Euro-

[18] These include European GNSS programmes (Galileo and EGNS), Copernicus, Horizon 2020, Trans-European Networks for Transport (TEN-T) and for Energy (TEN-E) and for Telecommunications.
[19] The member state shall, however, 'take utmost account' of the opinion and provide an explanation to the European Commission if it does not follow the opinion.

pean technology companies by investors from China. By acquiring European technology leaders, many Chinese companies want to close their technological gap to leading companies and improve their international competitiveness. In general, this need not be to the disadvantage of the European economy. Acquisitions of European firms by commercially driven investors would generally be unproblematic from an economic point of view (Klodt 2008). Commercially-driven investors will have an interest to continue using the acquired technology in Europe, whenever Europe has a competitive advantage in this regard.[20] Negative effects on the European economy would therefore be largely limited to cases in which an acquisition or subsequent technology transfer would take place mainly for non-commercial reasons and the technology would be transferred to China, although it would be most efficiently used in Europe.

In any case, screening and blocking the acquisition of European technology firms by foreign investors is hardly an appropriate instrument to prevent technology transfer or to defend the competitiveness of European industry. For the Chinese government or government-backed Chinese firms, there are just too many other legal ways of acquiring or transferring a specific technology, particularly when the current owner agreed to the proposed acquisition of his company. The current owner could, for example, sell the technology through patenting or licensing, or follow incentives by the Chinese government to invest and produce in China, possibly in a joint venture with a Chinese company. Alternatively, the owner could decide to develop the next generation of the technology in cooperation with the potential Chinese investor. The legal prohibition of all these alternatives just to slow down an outflow of technology to China cannot be an option for any open market economy, except possibly to avert genuine national security threats.

When it comes to maintaining the competitiveness and the technological lead of Europe's industry, the biggest challenge is not to prevent technology transfer abroad, but to ensure that Europe remains an attractive location for research and innovation. Investment in education, basic research and modern infrastructure, access to finance and human capital, innovation-friendly regulations and a general openness to new ideas are crucial here. It will be more important to ensure that European companies have access to Chinese markets and Chinese human capital and talent than to restrict Chinese access to European technologies and markets.

For all these reasons investment screening in the EU should be strictly limited to averting (plausible) threats to public order and security. In order to improve the legal certainty of investors and to prevent new hidden forms of protectionism, the legal basis for investment screening and its application to individual cases should aim to develop a narrow, transparent and precise understanding of what is meant by plausible threats to public order and security.[21]

Distinguishing between plausible security threats and implausible allegations of security threats is certainly no easy task. Over four decades of US experience, however, show that such a differentiation is possible. The 'Three Threat' framework developed in the United States could serve as a benchmark model for Europe (Moran 2017). This framework distinguishes between three distinct types of threats to national security that could result from foreign acquisitions, namely: (i) the leakage of sensitive technology or know-how; (ii) the denial or manipulation of access to a critical input; and (iii) infiltration, espionage and sabotage. It also highlights that the relevance and credibility of any of these potential threats for a particular acquisition depend on the level of damage that could actually be inflicted upon national security interests; and whether the acquisition or its blocking actually affect the likelihood of such an event. If, for example, the goods and services produced by the acquired firm or close substitutes were widely available and switching costs were low, there would not be any plausible security threat. And if alternative sources of the technology held by the acquired firm are widespread and easily accessible to the acquirer or its home government, security cannot be assured by blocking the transaction anyway (Moran 2017).

As regards the implementation of FDI screening in the EU, there are important arguments in favour of a close coordination between member states or even (partial) centralisation of FDI screening at EU level. Most importantly, as many companies in Europe have affiliates in several member states or own and operate trans-national infrastructures (e.g. in the energy, transportation, or telecommunications sector), the impact of a foreign acquisition on national security (if any) will often not be limited to the home country of the targeted company. In such cases decentralised and uncoordinated decision making by member states with very different attitudes and rules for security screening may easily lead to inefficient decisions and may cause conflicts between affected member states.

Centralisation could also be in the interest of foreign investors. Foreign investors, whether from China or any other third country, may find it easier to deal with one European set of rules and negotiate with just one European regulator than to negotiate with several national governments applying different national rules. In addition, it is expected that centralised decision-making by an institution at EU level will reduce the risk of politicisation of individual cases at member state level. It will also generally make it easier and less time-consu-

[20] If Europe has a competitive disadvantage in using the technology, a transfer of the technology to China would generally still be in the long-run interest of the European economy.

[21] This is all the more important at a time when the US administration justifies tariffs on steel and aluminium imports from allies such as Canada, Mexico and the EU by claiming that these imports threaten the national security of the United States.

ming for investors to obtain legal protection from the European Court of Justice in cases where a prohibition of an acquisition is contrary to European law.

Irrespective of the potential benefits, any attempt to establish centralised investment screening by a European regulator (be it the Commission, the Council or an independent agency) appears to be a 'mission impossible', however, in view of the opposition to be expected from member states.[22] Even a partial harmonisation of member states' investment screening mechanisms along the lines just described, and a better coordination between member states and Commission in screening individual acquisitions may be hard to achieve. The prospects of increasing the efficiency and coherence of FDI screening decisions, however, should be worth the effort.

Once again, the goal of a new framework for investment screening must not be to turn the EU away from its current openness to FDI. The aim should be to reduce concerns about possible security risks from foreign acquisitions by increasing the efficiency and the acceptance of FDI screenings on grounds of security and public order, which may actually help maintain societal and political support for the EU's current openness. Irrespective of whether, or in which form, the regulation proposed by the Commission will eventually be adopted, it will thus be crucial that the European Commission and the Court of Justice of the EU continue to oversee investment screening by member states; and to ensure that it is not misused for protectionist purposes.

However, maintaining support for the EU's current openness to FDI also from China will ultimately also require more openness and a level playing field for European companies in China. The best way for the EU to achieve this is through the ongoing negotiations of a comprehensive EU-China investment agreement.

NEGOTIATING AN EU-CHINA INVESTMENT AGREEMENT[23]

In February 2012, China and the EU decided to launch negotiations on a comprehensive EU-China Investment Agreement. This agreement should replace the 26 different bilateral investment treaties (BITs) that currently exist between EU members and China, and establish a coherent legal framework to promote mutual investments. For the EU, the new agreement should go significantly beyond the existing agreements. It should lower market access barriers for European investors in China (pre-establishment) and guarantee non-discriminatory treatment of investments already made (post-establishment). For China, the agreement should help ensure that European markets stay open for Chinese investment, despite increasing concerns about Chinese takeovers. Even although China and the EU share a common interest in such an agreement, there are also a number of contentious issues that hamper its conclusion. By the end of 2018 nineteen rounds of negotiation have been held without a final agreement having been reached so far.

Investment agreements traditionally do not contain any provisions to liberalise market access. This also applies to the existing BITs between China and EU member states, none of which features any such provisions (Berger 2013a). In its negotiations with China, the EU has made it clear from the beginning, however, that liberalising market access must be a core issue of its investment agreement with China. More specifically, the EU Commission is urging China to adopt a negative list approach granting pre-establishment national treatment to European FDI in all sectors not included in a predefined list. China traditionally refused to include any (significant) market access provisions into its BITs. However, after experimenting with negative lists of different lengths in its free trade zones and other selected provinces, China now appears willing to accept the negative-list approach in its investment agreement with the EU. Conflicts of interest remain, however, as to the scope of the negative list. China prefers a rather cautious and limited approach with a long negative list.[24] In contrast, since European markets are already largely open to Chinese investments, the EU strives for a greater symmetry and thus for a short negative list. For industries on the negative list, China would retain the right to restrict access for European investments. From the perspective of EU investors, it is also important, however, that such restrictions must not be more stringent for European investors than for investors from other countries (most-favoured nation treatment). In addition, some particularly pernicious types of conditions such as compulsory joint ventures or forced technology transfers should be completely ruled out as conditions for granting market access.

Both China and the EU agree that investment screening on grounds of national security or public order must be possible under the agreement. To ensure that screening procedures cannot be (easily) misused for protectionist purposes, however, the EU must have an interest in including general guidelines for investment screening into the investment agreement. These guidelines should, in particular, prevent an overly broad definition of the concepts of national security or public order. This seems to be particularly important in light of the overly broad definition of national security provided by China's National Security Law, which forms the basis for all rules and regulations relevant for national security, including national secu-

[22] This is even more so as the introduction of such a system would probably require an amendment of the EU Treaties.
[23] This section draws on Bickenbach *et al.* (2015).

[24] The first nation-wide negative list for FDIs in China that was published in mid-2018 still contained 48 restrictions and prohibitions *(Special Management Measures ('Negative List') for Foreign Investment in China, 2018 Version,* http://images.mofcom.gov.cn/wzs/201806/20180628220738627.pdf).

rity reviews of foreign investment.[25] This definition of national security does not only include military security but also covers civil and political security, economic security, and cultural and social security. Such a broad definition would give Chinese authorities an exceptionally wide degree of discretion in investment screening, implying high levels of uncertainty for European investors.

The main focus of BITs has traditionally been to protect investments once they have been made, and to ensure that these investments receive fair, equitable and non-discriminatory treatment (post-establishment national and most-favoured-nation treatment). This is also true for the existing BITs between China and EU member states. Despite these BITs, however, European companies in China currently still face numerous forms of unfair and discriminatory treatment. These relate, in particular, to subsidies or public procurement policies, the protection of intellectual property rights, or the targeted enforcement of regulation and competition law (Bickenbach *et al.* 2015). The reason why these practices are still possible despite the existing BITs between China and EU member states, is that these existing BITs exhibit a fundamental asymmetry regarding the level of protection that is granted to foreign investors. Whereas EU member states generally commit themselves to equal treatment of domestic and Chinese investments post-establishment, the implementation of national treatment of European investors in China is severely limited. Existing BITs usually contain provisions that allow China to retain existing laws and regulations that are incompatible with national treatment. China merely agrees not to increase discriminatory treatment and promises to progressively remove non-conforming measures (Berger 2013b). In the ongoing negotiation the EU is expected to change this practice and to demand concrete commitments from China to introduce post-establishment national treatment that will go significantly beyond what China was willing to promise in the past; or the progress it has recently made in some of the relevant policy areas.

Another controversial issue is the treatment of state-owned enterprises (SOEs). The EU's aim here is to ensure the competitive neutrality of SOEs. It has an interest, therefore, to include provisions that limit the many forms of preferential treatment of Chinese SOEs (direct subsidies, preferential access to capital and other production factors, preference in public procurement and in regulation) in the agreement and encourage greater transparency with respect to business operations and political linkages of SOEs. SOEs have been a focus of economic reforms in China for years. The aim of recent SOE reform, however, was not to reduce political influence on SOEs or to weaken SOEs' role in the economy. Instead, there has been a further politicisation of SOEs and a strengthening of their economic capacities (including through mergers). Powerful SOEs have become a key instrument of the government in pursuing its ambitious industrial policies, including its strategy of acquiring advanced technologies through outward FDI. It remains to be seen whether the EU and China can find a consensus on the highly sensitive SOE issue.

Last but not least, potential disagreement between China and the EU also exists with respect to the rules of investor-state dispute settlement (ISDS). The main question here is whether such disputes should be settled by recourse to traditional ISDS procedures or by implementing the permanent investment court system (ICS) proposed by the EU. The traditional ISDS system, which is based on commercial arbitration by *ad hoc* tribunals, has been heavily criticised by many European advocacy groups and citizens. In response to this, the European Commission proposed to reform the system by (i) ensuring a better protection of governments' right to regulate in the public interest, and (ii) setting up a public, permanent investment court for each trade or investment agreement.[26] The European Commission has made it clear that it wants to incorporate ICS in all its future investment agreements, including the agreement with China.[27] It is still highly unclear, however, whether China will accept the ICS. Beginning in the late 1990s China's BITs (including those with EU member states) contain the possibility of investor-state dispute settlement through traditional ISDS procedures. Moreover, only recently, China showed its interest in being more integrated into the traditional ISDS system by intensifying its engagement in the International Centre for Settlement of Investment Disputes (ICSID) at the World Bank in Washington DC and, at the same time, developing its own China-based commercial arbitration institutions. Against this background, it seems likely that China would prefer traditional ISDS over the ICS in the EU-China partnership. Given the Commission's commitment to the ICS and the fierce criticism of the traditional ISDS system within several EU member states, however this would hardly be acceptable for the EU.

Given the many contentious issues related to the agreement, it is not self-evident that the negotiations can be successfully concluded in near future. It was

[25] Back in 2015, the Chinese government published a draft Foreign Investment Law for public consultation; but the law has not yet entered into force (end of 2018). This law would *inter alia* provide a more specific legal base for national security reviews of FDI in China.

[26] By setting up a permanent tribunal with a pool of highly-qualified and independent judges, public access to all relevant documents and all hearings, and the right to appeal against verdicts, the ICS is expected to increase procedural transparency and improve legal certainty. In the longer term the European Commission hopes to replace the ICS by a new multilateral investment court that would rule on investment disputes arising from, in principle, all bilateral agreements in place.

[27] Key elements of the new system have already been incorporated into the EU's comprehensive economic and trade agreement with Canada, as well as in recent agreements with Singapore, Vietnam and Mexico. The ICS has not, however, been incorporated in the recently agreed EU-Japan Economic Partnership Agreement (EPA). As Japan appears to favour the traditional ISDS rejected by the EU, the agreement does not include specific rules for resolving investor-state disputes; talks between the EU and Japan continue on this issue.

reported, however, that at the last China-EU Summit in July 2018, the leaders from both China and the EU agreed to treat the negotiations on the agreement as a priority. Moreover, there are reasons to believe that the importance of the agreement for China has recently increased significantly. On the one hand, the strong increase in Chinese FDI into Europe and the debate it triggered have increased the importance of protecting unrestricted market access and non-discrimination for Chinese investments in the EU. On the other hand, the economic stimuli resulting from a successful conclusion of the negotiations could help China mitigate the negative consequences of its trade war with the United States. It may even help end the trade war. It would provide a solution to some of the issues that the United States has also raised with China (e.g. restrictive market access, forced technology transfers or the role of SOEs); and it would demonstrate that these issues could be solved through negotiations. To the extent that the EU-China agreement would give European companies a competitive advantage over their US counterparts, it would also increase pressure on the US administration to find a similar solution.

In conclusion, we would like to stress that the prospects for success of the two policy initiatives that the European Commission is currently pursuing to reform its FDI policy, particularly with regard to China, are by no means independent of each other. The prospects of defending the EU's openness to FDI (including from China) by passing a European framework that limits FDI screening to genuine threats to security and public order are much better if a comprehensive EU-China investment agreement could be concluded in near future. At the same time, maintaining the EU's openness to foreign investment while protecting security and public order would be a strong EU argument in negotiating an agreement that would ensure greater openness and non-discrimination against European FDI in China.

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