RECONNECT CHINA

POLICY BRIEF 5

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NAVIGATING EU-CHINA INVESTMENT DYNAMICS: SAFEGUARDING TECHNOLOGICAL KNOW-HOW WHILE FOSTERING COOPERATION.

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China's investment and acquisitions in the European Union have increased significantly in recent years, raising concerns about their impact on European economies and security. The dynamics of the EU-China relationship have evolved significantly over time, with the past year marked by a deterioration in bilateral relations. This deterioration has been linked to a growing number of issues, such as China's responses to EU sanctions on human rights, economic coercion affecting the single market, and its stance on the Ukraine conflict.

The EU faces the complex challenge of dealing with China as both a negotiationg partner, economic adversary and systemic competitor. This complexity characterises the current state of EU-China relations, where a variety of challenges and opportunities are emerging, driven by intertwined economic, political, and strategic factors.

This policy brief aims to examine the underlying dynamics of EU-China trade and investment, with a particular focus on technology, and the related concerns and challenges in building cooperation in this area. The first section provides an overview of the current state of Chinese trade and investment in the EU market, tracing its evolution over time and its growing reach in various sectors, particularly those involving cutting-edge technologies. Building on the identification of the two main concerns of Brussels in the second section – China's state-led investment strategies and technology transfer – the third section focuses on three key challenges in balancing opportunities and risks in EU-China relations: insufficient reciprocity and asymmetry in market access; growing economic and national security concerns; and fragmentation of EU rules.

TRENDS IN CHINA'S INVESTMENTS IN EUROPE

The central focus of business relations between the European Union (EU) and China centres around their strong trade and investment connections. China holds the position of being the EU's second-largest trading partner, with the US occupying the top spot. Notably, in 2020, China surpassed the US as Europe's primary trading partner in goods.[1] In 2022, the trade between the EU and China amounted to a substantial 856.3 billion euros.[2]

Over the past decade, Chinese investments in the European Union have experienced a significant upswing. The initial surge of Chinese foreign direct investment (FDI) in European infrastructure began in 2008 during the Global Financial crisis and the subsequent Eurozone debt crisis. Starting from 2013, the launch of the Belt and Road Initiative (BRI) and the economic reforms approved at the Third Plenum of the Eighteenth Congress of the Chinese Communist Party further bolstered Chinese FDI in Europe.[3] Over the past twenty years, an estimated cumulative total of 120 billion euros in Chinese FDI has flowed into the EU,[4] even though in 2022 they decreased 83 percent from their peak reach in 2016.[5]

However, global cross-border investment activities have generally declined since 2017, and Chinese global investment has not been an exception to this trend. Factors such as the COVID-19 pandemic and escalating geopolitical tensions, notably the Sino American trade war and the conflict in Ukraine, have contributed to a reduction in cross-border investments worldwide.[6] As a result, while 2021 witnessed a strong global recovery in FDI flows from exceptionally low levels in 2020 due to the pandemic, Chinese FDI in Europe hit a fresh decade-low in 2022, amounting to 7.9 billion euros, down by 22 percent from the previous year.[7]

Overall, China's investments in the EU have evolved and expanded both geographically (although primarily concentrated in the Germany, France, and the UK – which was an EU member until 2020) and across various sectors over time. During the past decade, the overarching Chinese investment strategy has been designed to move away from "irrational investment activities" that do not align with national strategic goals. Chinese FDI in the EU have shifted from "hardware" sectors like transportation infrastructure to include energy, telecommunications, and various high-tech industries, encompassing a wide range of cutting-edge technologies.[8]

While these investments bring economic benefits and enhance the competitiveness of many European industries, they also pose significant challenges, amplified by the escalation of geopolitical tensions and increased geo-economic competition in the current highly conflict-prone international landscape. The increased geo-politicisation of trade and investments[9], namely the "weaponization" of trade policies in great-power rivalries, with the consequent increasing influence of geopolitical considerations on decision-making processes in the field, has resulted in new concerns for Brussels regarding China's approach to economic statecraft and its potential to exploit the dependencies of other countries for strategic purposes.[10]

Main sources of concern toward China's FDI

EU concerns toward China's FDI primarily revolve around the role of the Chinese government in China's investment strategy and the associated risk of technology transfer from the EU to China.

a. China's state-driven investment strategy: from the Belt and Road Initiative to the Made in China 2025.

China's political economy is characterised by significant state interference with market forces, blurring the boundaries between the public and private sectors. This influence is evident in state-led initiatives such as the BRI, the Silk Road Fund[11] and Made in China 2025, which aims to position China as a leader in various high-tech sectors and create "national champions" through state funding, low-interest loans, tax incentives, and other subsidies. Critics argue that these policies distort markets and lead to overproduction and dumping.[12]

Moreover, although economic reforms in the 1990s reduced the role of state-owned firms in the economy, they still account for a substantial portion of GDP and approximately two-thirds of China's outbound investments.[13] Both private and state-backed Chinese companies have been encouraged to invest in foreign companies, particularly in the semiconductor sector, to gain access to advanced technology.[14] Investments aligned with these initiatives are viewed with suspicion by several countries, which fear that they may advance China's strategic objectives or provide unfair access to sensitive technologies. Concerns extend to potential espionage or cyber threats with relevant geopolitical and national security implications. For examples, Washington has raised concerns about Beijing's extensive and opaque subsidy framework, which it claims has facilitated the rise of Chinese tech giants like Huawei to dominant market positions.

b. Managing the Risk of Knowledge Leakage

Several EU countries have expressed concern about the risk of losing their technology-based competitive advantage to Chinese companies by licensing their patents, designs, software, trade secrets, and know-how. In particular, concerns over intellectual property theft and forced technology transfers imposed as conditions for investment in China have increased in recent years.

For instance, in early 2022, the EU launched a case against China at the World Trade Organisation (WTO), alleging that China was restricting the ability of European companies' to protect their high-tech patents.[15] This development reflects a shift towards a more competitive rather than complementary EU-China relationship especially in the area of investment, with the EU taking steps to address these challenges, including strengthening its technological sovereignty and reducing its dependence on Chinese imports. Recognising its loss of competitiveness in critical enabling technologies and its dependence on external sources, the EU is making concerted efforts to enhance "Europe's technological sovereignty" through initiatives such as the European Chips Act.[16]

Current Challenges

Recent global challenges have injected a new dynamic into the EU-China relationship. Since 2019, the EU has seen China as a multifaceted partner, involving cooperation, negotiation, economic competition, and systemic rivalry in various policy areas[17]. However, a significant shift occurred following a speech by European Commission President, Ursula von der Leyen, in late March. In her speech, von der Leyen made a strong statement, emphasising that "the imperative for security and control now outweighs the logic of free markets and open trade." "We must ensure that the capital, expertise and knowledge of our companies are not used to strengthen the military and intelligence capabilities of those who are also systemic rivals for us" – she said, underlining that this would affect sensitive technologies where investment could potentially contribute to the development of military capabilities that pose a risk to national security.[18]

Given this context, the EU faces the difficult task of balancing the promising opportunities with the considerable risks that define the main challenges in its relations and cooperation with China.

a. Lack of Reciprocity and asymmetry in market access:

The EU is actively seeking increased access to Chinese markets, but it continues to face challenges due to the relative closure of the Chinese market.

Significant asymmetries have emerged over time, as illustrated by the "Catalogue Guiding Foreign Investment in Industry," jointly issued by China's National Development and Reform Commission and the Ministry of Commerce,[19] listing various sectors where restrictions, limitations, or partnerships with Chinese companies are required for foreign entities. Nevertheless, in this regard China has recently announced its willingness to remove all restrictions on foreign investment in the manufacturing sector.[20] Overall, Chinese companies enjoy a more open environment in the EU.

This growing discrepancy in investment opportunities has been further complicated by the increasing politicisation of the Chinese business environment, making it even more challenging for EU companies to operate in certain sectors. In addition, new risk factors have emerged, including China's increased assertiveness in the multiple maritime and territorial contestations in which it is involved, and the supply chain disruptions resulting from China's zero Covid policy.

An attempt to address most of these challenges was the launch of negotiations in 2012 on an EU-China Comprehensive Agreement on Investment (CAI), which was concluded in principle in 2020. This was the most ambitious agreement that China had ever entered with a third party and its main aim was to establish rules for the conduct of state-owned enterprises and comprehensive transparency rules for subsidies. However, the life of the agreement proved to be remarkably short: only five months elapsed between the initial political agreement and the European Parliament's decision to block ratification in May 2021 bringing the process to a standstill.[21]

During the virtual EU-China summit in June 2020, President Ursula von der Leyen emphasised the need to "achieve a real level playing field" with China, encompassing trade, climate, technology, and the defence of multilateralism.[22]

However, it is becoming increasingly clear that the European Union needs to formulate policies suited to an era in which China may resist to reciprocity, even if a complete severance of ties with China is not a viable option for the EU.

b. The rise of Economic and National Security Concerns

Investment in critical infrastructure and sensitive technology sectors is a source of economic and national security concerns for the EU and its member states.

Economically, certain transactions have raised concerns about the future competitiveness of EU companies due to the outflow of advanced technologies in strategic sectors. In addition, national security concerns revolve around the potential risks associated with foreign control of strategic assets, the production of key defence components, and the risk of espionage or disruptive actions.

In the European Economic Security Strategy, the EU expressed its commitment to reducing risks related to vital technologies and strengthening its role as a leader in the global technology race.[23]

In the pursuit of this goal the EU aims to strengthen three investment-related mechanisms: i) a review of its inbound investment screening, which involves monitoring the acquisition of critical European assets or infrastructure by foreign companies; ii) increased cooperation on export controls, which regulates the sale of items such as weapons or espionage-related software to states identified as hostile; iii) the implementation of outbound investment screening.[24] Of these three, outbound investment screening is the most controversial, as it would give the EU new powers to monitor the outsourcing of vital industries and technologies to potentially problematic countries.

c. Coping with the EU Regulatory Fragmentation

Inconsistent rules across the EU and different national approaches to Chinese investment pose significant challenges and oversight gaps. Unlike trade issues, which are the exclusive competence of the European Commission under the EU Treaty, investment-related national security issues remain the exclusive competence of individual member states. The EU has adopted a framework for screening FDI that came into force only in 2020 ("FDI Regulation"). In fact, it was introduced largely as a result of pressure from Germany, France and Italy, which were concerned about the structural challenges posed by China's emergence as a growing source of FDI in Europe.[25] In those years the share of EU companies under Chinese control grew rapidly, from 1.4% in 2007 to 8% in 2015-16[26], raising concerns about a "lack of reciprocity and about a possible sell-out of European expertise".[27]

The EU's approach on the matter, for instance, differs from the comprehensive regulation of the US Committee on Foreign Investment in the United States (CFIUS), which operates at the federal level. The EU FDI Regulation aims to ensure a framework for "EU-wide coordination and cooperation".[28] Article 4(1) of the Regulation lists factors that member states may consider when assessing the impact of an acquisition on "national security and public order."[29] These factors include critical infrastructure, critical technologies, dual-use items, supply of critical inputs, access to sensitive information (including personal data), and media freedom. The EU is awaiting the results of an evaluation of the Regulation's effectiveness, expected by October 2023. This evaluation could pave the way for a revision of the Regulation, potentially giving the European Commission more powers.[30]

Member States have also adopted unilateral trade measures to ensure a level playing field for EU companies and to protect their technological assets. For example, the introduction of export restrictions on chip technology by the Netherlands in March 2023 can be seen as a reflection of the concept of "shared sovereignty" between EU institutions and Member States to protect Europe's technological sovereignty and leadership.[31]

CONCLUSIONS:

The European Union faces a multifaceted challenge in its relations with China, especially in the realm of investment, marked by a complex interplay of opportunities and risks. Brussels has therefore been working to develop strategies to cooperate with Beijing while safeguarding its technological know-how, economic interests, and national security.[32]

The prioritisation of improved market access for European companies and the pursuit of a more equitable playing field underline the importance of reciprocity in economic interactions. Alongside EU's efforts to develop a coherent investment strategy and its commitment to de-risking towards a more resilient and autonomous economic structure, particularly vis-à-vis China, the promotion of a constructive dialogue with China remains essential. Such an understanding is essential for the development of a holistic strategy to guide the EU's future engagement with China at the multilateral level.

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