

# *Kiel* Policy Brief

## The EU-China Bilateral Investment Agreement in Negotiation: Motivation, Conflicts and Perspectives

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## The EU-China Bilateral Investment Agreement in Negotiation: Motivation, Conflicts and Perspectives

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Since January 2014 China and the European Union (EU) have been negotiating a comprehensive bilateral investment agreement. In contrast to the EU-US negotiations on a Transatlantic Trade and Investment Partnership (TTIP), the ongoing negotiations between China and the EU have received little public attention so far. Still, a successful conclusion of these negotiations may be of great importance even beyond the EU-China investment relations. This holds in at least two respects. Firstly, a successfully concluded bilateral investment agreement may pave the way for a future EU-China free trade agreement. And secondly, looking beyond the bilateral relationship, the negotiations between the EU and China may make an important contribution to the establishment of a more liberal *global* investment framework. Currently, China is also negotiating an investment agreement with the US which is likely to take a similar form as that between China and the EU. In addition, provisions for the future liberalisation of bilateral investment flows are also an important part of the TTIP negotiations between the US and Europe. Rules and provisions, e.g., regarding market access, the prohibition of performance requirements or the transparency with respect to state-owned enterprises, that are part of all three agreements will “be elevated to a *de facto* global standard” (Berger 2014).

Against this background, the present Kiel Policy Brief analyses the key barriers investors from China and the EU currently face in the EU and China, respectively and provides a brief assessment of whether and how these key barriers can be dealt with in the comprehensive EU-China investment agreement currently negotiated.

### 1 Background and motivation for an EU-China bilateral investment agreement

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The (partial) liberalisation of foreign direct investment (FDI) undertaken by many countries in the world over the past decades has greatly accelerated the globalisation process of the world economy. In particular FDI from developed source countries to developing host countries has helped integrate more and more countries into the global economy. Through FDI foreign investors have brought in financial capital, advanced technologies and

technological and managerial knowledge which have been found to make substantial contributions to income growth and productivity enhancement in the developing host countries (e.g., OECD 2002). FDI does not only play a substantial role for the economic catch-up of developing countries, however. FDI has allowed investing firms – traditionally from the developed countries – to realise a more efficient international sourcing of resources and division of work (e.g., Lipsey 2002) that helped sustaining economic development in the home countries as well. More recently, some developing countries have themselves become increasingly important sources of FDI. This is true in particular for China. As part of its “going global” strategy officially launched in 2000, the Chinese government has started to actively promote outward FDI. As a consequence an increasing number of Chinese firms, including many state-owned enterprises (SOEs), have undertaken foreign direct investments both in developing and developed economies. A major aim is to increase firms’ international competitiveness through improved access to international markets and to various resources ranging from natural resources to technology and knowledge and skills.

To gain a competitive edge over other host countries in attracting FDI, many developing countries have concluded bilateral investment treaties (BITs) with potential FDI source countries. The intended aim of these BITs was to attract higher FDI inflows by providing investors from developed countries better protection against unfair and discriminatory treatment, by regulating direct and indirect expropriation, guaranteeing free capital transfer and offering foreign investors the opportunity to bring treaty breaches before international arbitration tribunals (e.g., Berger 2014).<sup>1</sup> As several developing countries and most prominently China have recently developed from ‘pure’ FDI host countries into increasingly important sources of FDI, their interest in concluding BITs has extended from providing safeguards for incoming investments to also include a better protection for their own FDI abroad (UNCTAD 2009).

Since 1982 China has signed bilateral investment treaties with more than 130 countries across different regions of the world (UNCTAD 2015a). Focusing on the European Union, China concluded such bilateral investment treaties with all twenty-eight EU member states except for Ireland.<sup>2</sup> The terms of the existing BITs between China and EU member states, however, differ substantially from each other with respect to the local treatment of foreign investments and the level of protection granted to foreign investors. In pre-1998 BITs provisions on non-discrimination of foreign investments were subject to far-reaching qualifications limiting the effective protection and there were either no or only very limited provisions for investor-state dispute settlement (ISDS) (Berger 2013b). By contrast, BITs signed after 1998 generally contain all standard provisions found in recent BIT practice, such as general principles of fair and equitable treatment, non-discrimination, full protection and

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<sup>1</sup> On the empirical evidence regarding the actual impact of such investment treaties on FDI inflows see Berger et al. (2011; 2013).

<sup>2</sup> More precisely, China has concluded 26 investment treaties with EU member states; 25 bilateral treaties with individual member states plus one treaty with Belgium and Luxembourg as a unit (the Belgium-Luxembourg Economic Union) (UNCTAD 2015a).

security, and full ISDS with respect to all provisions under the treaty (Berger 2013b; European Commission 2013). Even across the post-1998 BITs there are still important differences, e.g., with respect to the scope of ‘most favoured nations’ treatment or specific ISDS provisions (European Commission 2013), however. As a consequence there are widely different rules and different levels of protection for investments applying to investors from different EU member states, and there are also different provisions applying to Chinese FDI in different EU member states leading to increased information costs and distorted investment decisions.

Against this background, the EU empowered by the Lisbon Treaty and China decided at the EU-China Summit of February 2012 to launch negotiations for a comprehensive EU-China Investment Agreement, which were finally opened with a first round of negotiations in Beijing in January 2014 (European Commission 2014).<sup>3</sup> One major aim of the intended investment agreement is to replace the current legal patchwork of 26 different bilateral investment treaties between China and individual EU member states and to “create a coherent legal framework for mutual investment flows” (Berger 2014: 12). It also aims at further fostering the bilateral FDI flows, which have been relatively low as compared to the intensive trade relations between the EU and China (for quantitative information on the bilateral investment flows between China and the EU see Appendix.).

While China’s investments in the EU are still comparatively low, they have increased strongly in recent years. However, several of the existing BITs between China and EU member states, particularly those concluded in the 1980s and 1990s mainly reflect China’s interest as a recipient of FDI but have been playing a limited role only in protecting Chinese overseas interests, which have become important particularly after China started its “going global” strategy (He and Wang 2014; European Commission 2013). These older BITs are thus considered to be highly outdated by now. In its negotiations with the EU China therefore aims at an agreement that better reflects its interests as both a leading recipient and an increasingly important source of foreign direct investments.

The new agreement is planned, however, to go far beyond even the most comprehensive of the existing bilateral treaties, which mainly focus on the protection of foreign investments already made (post-entry treatment). Particularly in the view of the EU, improving market access of European investors by including appropriate provisions on treatment of investors wishing to make investments in China (pre-entry treatment) is a decisive issue in its negotiations with China. Overall, the European Commission pursues four main objectives in its negotiations with China (European Commission 2013): (i) improving legal certainty regarding the treatment of EU investors in China, (ii) improving the protection of EU

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<sup>3</sup> Through the Lisbon Treaty EU member states have conferred exclusive competence in the field of foreign direct investment to the European Union which shall contribute to the progressive abolition of restrictions on foreign direct investment (Articles 3(1)(e), 206 and 207 of the Treaty on the Functioning of the European Union). This implies that “under the current post-Lisbon investment regime, Member States cannot negotiate or renegotiate BIT any longer, unless empowered by the European Commission” (European Commission 2013: 16).

investments in China (iii) reducing barriers to investing in China and (iv) increasing bilateral FDI flows. While objectives (i), (ii) and (iv) are to be considered typical objectives of traditional BITs, this is certainly not the case for objective (iii). The inclusion of market access provisions in the form of effective non-discrimination at the pre-entry phase (pre-entry national treatment) to ensure that foreign investors have the same market access as domestic investors is clearly beyond the scope of traditional BITs. In particular none of the existing BITs between China and EU member states deals with the question of market access for prospective investors (pre-entry treatment); all of them are limited to provisions dealing with post-entry protections of investment only (European Commission 2013).

While the focus of recent BITs concluded by China has clearly been on the post-entry protection of investments, China seems to also pursue market access objectives in its current negotiations with the EU. While EU industries are generally very open to foreign investments, including investments from China (for more on this see below), there have been concerns among Chinese leaders and investors about alleged growing protectionist sentiments in Europe with respect to FDI from non-traditional sources like China. China therefore has a key interest safeguarding the EU's current openness for the future. In earlier talks with the EU, China has also raised concerns on a number of barriers which its investors are currently facing when investing in the EU, including sectoral investment restrictions and ex ante authorisation procedures to different degrees. China has also complained about large difficulties and allegedly unfair treatment with respect to obtaining visas and work permits for their Chinese staff and has linked this to the market access question for Chinese of investment (European Commission 2013). In addition, some experts point out that reform-minded Chinese leaders may be interested in negotiating market access provisions with the EU also as a strategic instrument for pushing domestic reforms and committing to a more liberal regime on FDI inflows which is not undisputed within the Chinese leadership (Zhang 2015; Król 2013). For all these reasons, it is also in China's interest to include the liberalisation of market access regulations in its negotiation agenda with the EU.

Overall, both partners, China and the EU seem to have a genuine interest in successfully negotiating a bilateral investment agreement with each other and general objectives of the two parties seem to be broadly reconcilable at least in principle. As we will argue in the following there are several important issues of potential disagreement, however. Negotiations will likely to be long and difficult and success is far from being guaranteed.

## 2 Key barriers to FDI in China and the EU

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The recent stagnation of EU direct investments into China (see Appendix) has been attributed partly to a more difficult economic environment in China characterized, e.g., by rising production costs including wages that reduce profit margins and intensified domestic competition (He and Wang 2014). There have also been complaints about persisting investment barriers or even deterioration investment conditions (ibid.).

In fact, China maintains a more restrictive foreign investment regime than the EU member states and most of their main trading partners. This is reflected, e.g., in the OECD FDI Regulatory Restrictiveness Index, according to which China has the most restrictive regulations on foreign investments of all countries covered (OECD 2015).<sup>4</sup> On a scale from 0 (open) to 1 (closed) the FDI Regulatory Restrictiveness Index for China takes a value of 0.418 in 2014, which is the highest value of all 58 countries considered. China's value is much higher, in particular, than the corresponding values for the EU member states, which range from 0.004 in Luxemburg to 0.106 in Austria<sup>5</sup>, and it is also much higher than that for the other BRICS countries (India (0.263), Russia (0.181), Brazil (0.101), and South Africa (0.055)). Furthermore, while the index for China has improved substantially compared to 1997 (0.626), the first year for which the index is available, it has improved only very little since 2010 (0.421).

## 2.1 Market access restrictions

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### *Industry restrictions and screening and approval processes*

The very high level of China's FDI Restrictiveness Index suggests that the relatively low amount of EU investment in China may in fact be attributable, at least in part, to the strict regulatory restrictions in China. Among the four types of policy measures considered to measure the FDI Restrictiveness Index, China's policies on 'foreign equity limitations' and on 'screening and approval mechanisms' have been evaluated as being the most restrictive by the OECD. This evaluation result is in line with the results of a public consulting of the EU Commission, which found that factors such as "prohibition to invest and/or limited scope of business", "foreign ownership limitations", "joint venture requirements", "regulatory approval procedures", and "licensing requirements and procedures" have been considered most problematic for firms investing or willing to invest in China (European Commission 2013: 12).

Market access barriers persist at various levels; they can be included in general rules or sector-specific legislation or can result from poor implementation and enforcement of these

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<sup>4</sup> "The FDI Regulatory Restrictiveness Index ... measures statutory restrictions on foreign direct investment across 22 economic sectors. It gauges the restrictiveness of a country's FDI rules by looking at the four main types of restrictions on FDI: 1) Foreign equity limitations; 2) Discriminatory screening or approval mechanisms; 3) Restrictions on the employment of foreigners as key personnel and 4) Other operational restrictions, e.g., restrictions on branching and on capital repatriation or on land ownership by foreign-owned enterprises. Restrictions are evaluated on a 0 (open) to 1 (closed) scale. The overall restrictiveness index is the average of sectoral scores. The discriminatory nature of measures, i.e., when they apply to foreign investors only, is the central criterion for scoring a measure. State ownership and state monopolies, to the extent they are not discriminatory towards foreigners, are not scored" (OECD 2015).

<sup>5</sup> Only 24 of the 28 EU member states are covered by the index. For most (19 of 24) EU member states, the FDI Regulatory Restrictiveness Index was lower than 0.05. Among the largest EU member states this was true for Germany (0.023) and France (0.045) but not for Italy (0.052) or the United Kingdom (0.061).



rules. With regard to the overall framework for inward FDI in China, the key guidelines are contained in the *Catalogue for the Guidance of Foreign Investment in Industries* (hereafter, the Catalogue), which is maintained by the Ministry of Commerce (MOFCOM) and the National Development and Reform Commission (NDRC). Since its first legal introduction in 1995 the Catalogue has been regularly revised and updated reflecting the changing focus of China's industrial economic policy and specific foreign investment objectives. The most recent revision of the Catalogue came into force in April this year.

The Catalogue delineates industries of the economy where foreign investment is either *encouraged*, *restricted* or *prohibited*. Investments in industries not listed in the Catalogue are considered *permitted*. In addition to this basic classification of different industries, the Catalogue may also require that investments in specific industries take certain ownership forms (such as a domestic-foreign equity joint venture) and/or that the foreign shareholder's proportion of investment in the enterprise may not exceed a certain percentage (e.g., 49% or 50% of total equity) (US Chamber of Commerce 2012). These mandatory joint ventures and equity requirements are of great concern to many European investors. These concerns are aggravated by the fact that these requirements may often lead to unwanted transfers of key technologies and intellectual property that are frequently even prescribed by the Chinese authorities (European Commission 2013).

An industry's classification in the Catalogue carries implications beyond whether foreign investment is possible at all. Different designations often lead to different levels of approval scrutiny or more or less stringent application requirements for prospective investors. FDI in encouraged industries, which are considered by the Chinese government as key industries that should be further developed in China to support China's sustainable economic growth, may enjoy several benefits such as custom and tax advantages and a lower level of required screening and approval procedures (Thelle et al. 2012). Despite its encouraging feature, investments in some of the encouraged industries are allowed only in specific ownership forms, for example, equity or cooperative joint venture. Generally, such ownership requirements are more stringent (e.g., specified foreign ownership caps) and the approval processes are stricter for the restricted industries.<sup>6</sup> In addition to the limitation spelled out by the Catalogue, industries can be subject to numerous limitations and conditions that are not specified in the Catalogue but in specific industry plans or regulations. These may include more rigorous domestic equity ownership and government approval requirements than those called for under the Catalogue (US Chamber of Commerce 2012).

In the latest revision of the Catalogue which came into force in April (NDRC and MOFCOM 2015) restrictions on foreign investment in several areas have been either removed or weakened but there have also been some new restrictions. Compared to the 2011 version of the Catalogue, the list of restricted industries was substantially shortened from 79 to 38 industries. While most liberalisations relate to manufacturing sectors, there has also been some limited progress in service sectors such as the real estate sector and the

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<sup>6</sup> Obviously, foreign investments are completely ruled out in "prohibited industries".

non-banking financial industry. The list of prohibited industries was slightly shortened from 38 to 36 industries as well. At the same time, some industries such as online publishing and consultancy on Chinese legal issues are newly declared as prohibited industries, however. Overall, the number of industries for which Chinese-controlled joint ventures are required is reduced from 44 to 35 and the number of industries requiring joint ventures with Chinese partners, but allowing foreign control, is reduced from 43 to 15 (NDRC 2015). Moreover, the last remark in the 2011 Catalogue that ‘provisions in other regulations and industrial policy shall prevail’ was removed from the 2015 Catalogue. Instead, only regulations shall prevail, if they are specified by law or by international treaties. This restricts the Chinese governments’ discretion in arbitrarily imposing further restrictions upon foreign investment.

Two other economic reforms that have been announced recently may have a stronger impact on future market access conditions than the recent changes of the Catalogue:

(i) In January 2015 MOFCOM released a new draft Foreign Investment Law for public comment. If implemented, the new law would abolish the case-by-case approach to regulating foreign investment and introduce the principle of ‘national treatment’ for some sectors, while enumerating all instances where FDI is treated less favourably than domestic investments on a ‘negative list’.

(ii) Such a ‘negative list’ approach has already been implemented in the recently established four Free Trade Zones (FTZs) in Shanghai, Guangdong, Tianjin and Fujian. The *Negative List for Foreign Investment* provides an outline of all sectors where foreign investment is subject to specific regulations (including restrictions on business activities, ownership requirement, foreign equity cap etc.) implying that in all other sectors foreign investors will receive equal treatment to domestic investors (State Council 2015).<sup>7</sup> There is one important exception to this rule, however. All foreign investments that may have bearing on China’s national security are subject to an extended Foreign Investment National Security Review (for more on this see below). For the four FTZs the negative list approach is an important step towards improving market access. In its current form the impact of the approach will likely be rather limited, however, due *inter alia* to the fact that the Negative List is still quite long. In addition it remains to be seen whether the national treatment is actually enforced for the sectors not on the list.

Under China’s current foreign investment regime, foreign investors may, in principle, invest in any non-prohibited industry, but they can do so only after obtaining Chinese government approval for every specific investment project. China approves foreign investments on a case-by-case basis following a multi-stage review process that involves multiple government agencies. According to the US Chamber of Commerce the [general] screening and approval process for inbound FDI usually involves eight different types of

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<sup>7</sup> “The new list is intended to reflect solely where foreign investors are treated differently from Chinese entities” (Dezan Shira & Associates 2015). Thus, it does not list any restrictions that apply to both foreign and domestic firms.



approvals, though the required approvals and the processes for obtaining them may vary, depending *inter alia* on the specific industry requirements and/or local regulations (US Chamber of Commerce 2012: 18).

According to foreign investors, types of approvals that are most likely to create problems of market access and discriminatory treatment for potential foreign investors include (i) the *Anti-monopoly Law Review* (conducted by MOFCOM), the *Project Approval* (National or Local Development and Reform Commission or State Council), the *Foreign Investment Approval* (MOFCOM or local Commerce Department) and the *Regulatory Approval* (relevant industry regulator, if applicable) (US Chamber of Commerce 2012). Another increasingly important part of the overall approval process is the National Security Review process.

In several cases, the rules governing the individual approvals processes have been changed several times over recent years. Although some changes are actually investor-friendly, these frequent changes have contributed to the opaqueness of the overall process. It is difficult for foreign firms to obtain a clear overview of all the relevant and frequently changing rules and regulations, not to mention the fact that some investment conditions and requirements are even given orally during the approval processes only (US Chamber of Commerce 2012). All these make it difficult for foreign investors to go through the screening and approval processes efficiently. Moreover, despite a number of general similarities the approval process for foreign investors can be markedly different from, and will usually be more stringent than, the process for domestic investors.<sup>8</sup>

According to foreign investors, three main characteristics of the investment approval process, in particular, tend to foster an unequal treatment of foreign investments (US Chamber of Commerce, 2012): (i) industrial policies designed to support the development of domestic industries and to foster national champions often favour domestic competitors, (ii) inbound FDI approval processes are rather opaque and accord broad discretion to responsible approval authorities that are explicitly mandated to help China achieve its industrial policy goals, and (iii) often there is a lack of effective recourse, if aspiring foreign investors believe that the approval authorities have not complied with international commitments or China's own regulations. Foreign investor often find it difficult to produce evidence for such non-compliance (e.g., because reasons for rejecting investment applications are often very broadly defined, or because approval authorities often rely on oral communications to convey specific conditions of approval), and fear retaliation if they "challenge the decisions of approval authorities, who have considerable power to affect companies' business prospects in China" (US Chamber of Commerce 2012: 62).

Different from the situation in China, the market access regime for foreign investors (including investors from China) to the EU is generally very open. Notwithstanding a number of country- and industry-specific exemptions, market access for foreign investors is generally

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<sup>8</sup> Even where regulations do not provide for disparate treatment of foreign and domestic investors, responsible agencies often treat applications of these parties differently in practice (US Chamber of Commerce 2012).

free in the EU, as the EU applies the principle of free movement of capital not only to the EU member states but also to third countries (Article 63(1) of the Treaty on the Functioning of the European Union).

While details may differ between individual member states, there is generally no specific investment legislation and there are generally no restrictions limiting the establishment of new companies. Anyone can establish a business – irrespective of nationality or place of residence. There are no specific restrictions on the choice of legal company form and there are no requirements as to a minimum percentage of domestic shareholdings. The rules for the establishment and registration of new companies are generally the same for domestic and foreign investments (for the case of Germany see GTAI 2015).

This generally very liberal investment regime of EU member states is confirmed by the OECD FDI Restrictiveness Index, where all EU member states covered are rated open both overall and for most individual industries. Industry-specific FDI restrictions in individual member states exist, however, in some business services (including real estate) as well as in electricity and transport sectors. In the infrastructure sectors, in particular, there are also a number of restrictions resulting from the existence of state ownership and state monopolies.<sup>9</sup> As China has developed substantial capacities and know-how in some of these infrastructure industries over the last decades, Chinese firms might well benefit from improved access to these industries in the respective member states (Król 2013).

Despite these exemptions Chinese investors generally perceive the EU investment environment as open and welcoming of Chinese investors according to a recent study of the European Union Chamber of Commerce in China (EU Chamber of Commerce in China 2013). At the same time 78% of respondents from Chinese enterprises report operating difficulties on the ground in the EU (ibid.). These difficulties have little to do with legal uncertainty or discrimination, however, but are generally the result of a “lack of experience in operating in an unknown – and highly regulated – market” (Berger 2013a). Many of the reported operating difficulties relate to labour law issues, including social security, labour unions and contracts (29%) or tax regulations and accounting standards (28%) (ibid.).<sup>10</sup>

The most frequently cited problems, however, relate to the issue of visa, and residence and working permits for Chinese employees of Chinese enterprises investing in the EU. Such problems were reported by about 32% of respondents. They were considered to be particularly problematic when Chinese managers plan to oversee new operations in Europe quite at the beginning of the investments. Difficulties in temporarily transferring Chinese staff to Europe due to strict visa regulations make the knowledge transfer from the Chinese parent company to the EU more difficult (EU Chamber of Commerce in China 2013). According to

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<sup>9</sup> These restrictions are not taken into account by the index as long as they are not discriminatory towards foreigners.

<sup>10</sup> Another set of operational challenges faced by Chinese firms in Europe relates to financing issues. For example, according to CHKD (2014) some companies in Germany experienced a worsening of their credit ratings by German banks after Chinese investors became the main shareholders in the companies. In some cases German banks were unwilling to grant further loans.

the OECD FDI Regulatory Restrictiveness Index all 24 EU member states covered have actually very low statutory 'restrictions on the employment of foreigners as key personnel' (index values at or below 0.05). This assessment does not include the generally much more stringent visa and work permit rules for lower management or rank and file employees<sup>11</sup>. Against this background the issue of visa and work permits is likely to be an important topic for China in its negotiations on the planned investment agreement.

### *National security reviews*

A potentially important step of the general investment approval process for foreign investment in China is the national security review. In 2011, the General Office of the State Council released a *Notice on the Establishment of the Security Review System for Mergers and Acquisitions (M&A) of Domestic Enterprises by Foreign Investors* (hereafter, the Security Notice) which requires foreign firms which plan to obtain actual control of a domestic firms in sectors related to the military, or associated with national defence and national security (including key technologies, major equipment manufacturing industries, important agricultural products, energy and resources, infrastructure, and transportation services) to be subject to the national security review. The Security Notice specifies that the national security review will examine not only the potential influence of such M&A on national defence and security but also the potential influences on national economic stability and social order.

In 2015 the General Office also released a comparable document to regulate the national security review for foreign investment in the four FTZs in China. In addition to the already quite broadly defined criteria listed in the Security Notice, this new document requires the national security review to take into consideration the impact of foreign investments on national cultural and social morality/public ethics and on internet security. Probably even more important is that the national security review is no longer restricted to M&A only but is required for all types of foreign direct investments. This extension of national security reviews at least partially runs counter to the commitment of 'national treatment' for investments not covered by the 'negative list'. While the general intention of keeping national security risks in check while opening more industries to foreign investments is certainly a legitimate goal, the very broad application of the review to all foreign investments and the very broad and vague criteria to be considered increase uncertainty for investors and could invite (additional) opportunities for discriminatory treatment of foreign investors.

Of course, national security reviews for foreign investment are not exclusive to China. In fact, most Western countries do execute such reviews. In the EU, issues concerning national security and defence and thus also national security reviews for foreign investment fall within the competence of the individual member states. Accordingly there is no "EU national security review system" in place, and the national security review systems of the individual

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<sup>11</sup> These rules vary between EU member states and they also vary between employees from different home countries (for a brief overview of German visa and work permit rules see GTAI (2015) <<http://www.gtai.de/GTAI/Navigation/EN/Invest/Investment-guide/Coming-to-germany/who-needs-a-visa.html>>.

member states vary quite substantially (for an overview see Nicolas 2014).<sup>12</sup> While a majority of member states have not adopted any formal national security review system for foreign investments, some major EU countries (including Germany) have recently amended their national security review policies so as to make them more restrictive. While these amendments are generally triggered by increasing concerns about investments by (Chinese) state-owned enterprises or sovereign wealth funds, the restrictions do not target investors from any specific country, however (Nicolas 2014). As a general rule, even after these amendments individual member states “have been very open to Chinese investment – including some sectors that might be considered as strategic or sensitive” (Eaker and Sun 2014: 53).<sup>13</sup> The fragmented and partially very liberal system of national security reviews in the EU has periodically been questioned by commentators from academia and some EU authorities, however. In light of an expected strong increase of Chinese investments touching upon so-called strategic or sensitive sectors within the EU member states, there have been repeated calls for a more unified European approach to regulating foreign investments (see Nicolas 2014; Eaker and Sun 2014).

The various market access restrictions sketched in this section are expected to play a major role in the ongoing negotiations between China and the EU, bearing in mind both the key relevance of market access considerations for both parties and the high dynamics and variety of the related regulations in the current systems.

## 2.2 Post-entry discriminatory treatment of foreign investors

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Contrary to the pre-entry treatment of prospective foreign investors, China claims to generally provide non-discriminatory treatment of foreign investments once they have been established (post-entry treatment). Several of the bilateral investment treaties China has signed with individual member states contain provisions on fair and equitable treatment, non-discrimination and protection and security of foreign investments. Despite these commitments of the Chinese government, European investors regularly complain about frequent and in several cases even systematic discrimination and insufficient protection of their investments. These complaints refer *inter alia* to the discriminatory treatment regarding government financial support and government procurement, the protection of intellectual

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<sup>12</sup> The EU does, however, enjoy an exclusive competence to review and approve M&A that have a “community dimension” (i.e., that have significant impact upon inter-state or ‘EU-wide’ competition). Foreign investors looking to acquire a European business may thus be subject to both EU Commission review and approval concerning competition law and individual member state’s national security review (Eaker and Sun 2014). “While the European Merger Regulation ... recognizes that Member States may take appropriate measures to protect certain ‘legitimate interests’ such as public security, plurality of the media and prudential rules, the scope of these ‘legitimate interests’ has been narrowly interpreted by the European Commission ... In fact, Member States have rarely been successful in blocking foreign acquisitions on ‘legitimate interests grounds’ (Zhang 2012: 43).

<sup>13</sup> This is generally deemed to be true in particular in comparison to the US system of national security reviews (e.g., Jungbluth 2013; EU Chamber of Commerce in China 2013).

property and key technologies and the targeted enforcement of Chinese laws and regulations, e.g., in the area of competition and antitrust policy.

#### *Government financial support and government procurement*

In public consultations and business surveys performed or commissioned by the European Commission European investors have underlined the negative impact and unlevel playing field created by discriminatory Chinese subsidy and public procurement policies (European Commission 2013). In China, a large number of programs have been established at various levels of government that provide financial support to companies – e.g., in the form of grants, loans, subsidies or even low-priced land – but may exclude foreign invested enterprises either explicitly or by administrative practice (Covington & Burling LLP 2014).

Moreover, Chinese firms, particularly state-own-enterprises (SOEs), are perceived to be treated more favourably than foreign firms in public procurement and bidding procedures (European Commission 2013). China's *Government Procurement Law* (which entered into force in January 2003) institutionalised an active 'Buy Chinese' clause: The law explicitly states that government authorities should procure domestic goods, services and works unless (1) such products cannot be obtained in China under reasonable business conditions or (2) the products are to be used abroad or (3) otherwise provided by other laws or regulations. Based on this law, the Ministry of Commerce, the Ministry of Finance and the State Council of China released various related regulations and opinions on procurement that tightened up the 'Buy Chinese' provisions even further in practice. A particular problem is that the law does not define the term 'domestic', leaving it unclear which items the government considers 'domestic' for procurement purposes. In particular, it remains unclear, whether or under what conditions goods and services produced by foreign-invested firms in China are to be considered 'domestic' for procurement purposes. This gives authorities substantial discretion in placing their procurement orders. In January 2015, the State Council released the *Regulations for the Implementation of the Government Procurement Law* which came into force in April the same year. However, this document is still not able to clarify the critical point regarding how to define 'domestic' products in the Government Procurement Law.

Government procurement has often also been used to stimulate the development and sale of home-grown technologies by promoting the procurement of 'indigenous innovation products'. For example, in the *Science and Technology (S&T) Advancement Law* government procurement is explicitly specified as an instrument to encourage indigenous innovation and support the development of key industries identified by the government. Following the S&T Advancement Law, several regulations were released to explicitly use government procurement as an instrument to promote indigenous innovation.<sup>14</sup> Although these regulations

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<sup>14</sup> For example, it is clearly indicated in the *Regulations of Evaluation and Approval of Government Procurement of Indigenous Innovative Products* that such products receive preferential treatment (e.g., bidding price discount etc.) in the bidding competition. If, however, no domestic products as such are available and authorities need to buy foreign products, foreign companies willing to transfer or

have been officially abated in 2011, there have recently been reports about new problems with the linkage between government procurement and indigenous innovation policy still being made at provincial level. More generally, the fact that government procurement can be potentially used to support China's economic developing target of becoming a leading innovation country still has its validity due to the S&T Advancement Law.

The problem is aggravated by the fact that for 'non-domestic' firms China has not yet made any substantial multilateral or bilateral commitments concerning government procurement (European Commission Directorate-General for Trade 2015). When China joined the World Trade Organisation in 2001, it also committed to negotiate its accession to the WTO *Government Procurement Agreement* (GPA) and to join the agreement as soon as possible (the EU, representing the 28 member states, is one of the founding members of the GPA).<sup>15</sup> Today, negotiations are still ongoing and China is still not a GPA member. Only by the end of 2007, China submitted its initial WTO GPA offer, which has been revised several times since then. All offers submitted were considered unacceptable by the GPA partners as a basis for accession negotiations, however. While the most recent, fifth revised, offer submitted in December 2014 includes a number of important improvements, it is as regards coverage still far from being satisfactory for the main GPA partners (ibid.).

#### *Protection of intellectual property and key technologies*

One of the most important concerns for European firms investing in China is the protection of intellectual property rights (IPR). Despite substantial progress in China's patent protection system, many European firms still consider an insufficient protection of intellectual property rights and key technologies a major barrier to investing in China. As China is gradually shifting from low-end manufacturing to an innovative economy, the issue of protecting IPR is even gaining in importance for European companies (BUSINESSEUROPE 2015).

Since joining the World Intellectual Property Organisation (WIPO) in 1980, China has made substantial progress in its IP legislations and has joined several international agreements and organisations in relation to IP. As member of the WTO, China is also a party to Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). The first version of China's *Patent Law* became effective in 1985 and has since been amended several times with its current version becoming effective in 2009. Shortly after that, the *Implementing Rules of the Patent Law* were revised as well. The *Measures of Executive Enforcement of Patents* which became valid in 2011 were revised again in 2015 in order to, on the one hand, support the enforcement of the Patent Law and, on the other hand, deal

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transferring key technologies to Chinese companies should be considered first (*Regulations of Contract Management for Government Procurement of Indigenous Innovative Products*).

<sup>15</sup> Within the framework of the WTO the GPA aims at opening up the government procurement markets among the signing members. The agreement encourages the establishment of comparable rules among signing parties to support an open, fair as well as transparent competition among foreign and domestic bidding parties in the government procurement markets (WTO 2015). Currently the GPA has 17 parties comprising 45 WTO members.



with new IP issues emerging from the digital economy. These efforts reflect the fact that the Chinese government has put great importance on the issue of IP protecting for quite some time now (EURObiz 2015).

As a consequence China has by now a comprehensive system of intellectual property laws and regulations that meet international standards. Against this background many foreign investors are still concerned about IPR violations and counterfeiting (European Commission 2013). The main issue here is the lack of an effective enforcement of China's IPR laws and regulations by the responsible administration and courts. The compensation of damages for patentees suffering infringement is still very low and not comparable with those awarded in other jurisdictions. In addition, there is a lack of judicial expertise in high-tech cases and applications of the law across different courts are often inconsistent. Moreover, the execution of judicial rulings remains very difficult and costly undermining the protection afforded to rights holders (The Economist Intelligence Unit 2013; BUSINESSEUROPE 2015).<sup>16</sup> All in all, while the IP protection system in China has made substantial progress over the last decades there is still ample room for further improvement. A closely related issue that is also of increasing importance to European firms refers to the patent prosecution system. The problem here is to create a level playing field and guarantee non-discrimination in the field of patent applications (BUSINESSEUROPE 2015). Currently there is a "perception of bias towards domestic companies applying for patents in protected industries" (The Economist Intelligence Unit 2013: 42).

On the other hand, in its 2014 survey among Chinese companies in Germany the CHKD (CHKD 2014) revealed complaints about some German companies abusing Germany's strong IPR protection system for their own business interests. In case of suspected IP infringements some German companies tended to apply for temporary injunction from courts even without sufficient and significant evidence. As a consequence, products of Chinese companies are often banned from trade fairs and exhibitions by the German authorities. In addition to the financial losses this may also lead to losses of reputation of the affected Chinese as well as of Chinese companies in general.

Another related issue is that of standard setting, and IPR-based standardization, in particular. China has repeatedly been accused of artificially erecting trade barriers through standardisation.<sup>17</sup> Of course, similar accusations have been raised against other major standard setting countries including, e.g., Germany and the EU as well. Companies from both sides regularly complain that established domestic enterprises are treated more

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<sup>16</sup> These problems have not been solved by the deployment of specialized IT judges more than a decade ago. In late 2014/early 2015 China has now set up specialized courts to handle IP cases in Beijing, Shanghai and Guangzhou. Due to venue requirements (the new courts are responsible only for Beijing, Shanghai and Guangzhou) and subject matter limitations, their effects are likely to remain limited as well, however.

<sup>17</sup> A prominent example is the third-generation mobile phones standard (TD-SCDMA), which has been declared as the country's standard of 3G mobile telecommunication by the Ministry of Information Industry of the People's Republic of China in January 2006.

favourable in standard setting leading to an unfair competition between these firms and incoming foreign investors. In the case of China, there are also a number of more specific complaints, however. Despite China's WTO commitment to provide a more transparent standard-setting process, foreign companies frequently complain that the standard setting process is opaque, often limiting or even precluding foreign companies to participate (Covington & Burling LLP 2014; BUSINESSEUROPE 2015). This lack of participation is a particular concern given China's alleged insistence on deviating from internationally recognised standards and developing its own indigenous standards in order to support domestic industrial policy (ibid.). The increasingly large number of indigenous (sometimes region-specific) standards that are often incompatible with established international standards and the opaque standard setting process may substantially increase operating costs and uncertainties for foreign investors, including the costs of acquiring and continuously updating information on relevant standards and, most importantly, the costs of adjusting their products to fulfil changing standard requirements. In addition, there are important IPR protection concerns related to standard-setting. More specifically, there have been claims that China is misusing its standard-setting systems as a means of forcing foreign investors to disclose sensitive technological information and to license or transfer patented technology on unfavourable terms and royalty rates to support industrial policy purposes (Breznitz and Murphree 2013). Some companies are pressured to accept such terms in order to be able to participate in the standard-setting processes (Covington & Burling LLP 2014).

#### *Targeted enforcement – competition policy*

Targeted enforcement of Chinese laws and regulations against foreign-owned firms is a common complaint of foreign investors in China (Covington & Burling LLP 2014). A policy field where such complaints have increasingly been brought forward recently is China's competition policy and the enforcement of China's Anti-Monopoly Law.

China's *Anti-Monopoly Law* (AML), adopted in 2007 and entering into force in January 2008, is in many respects compatible with antitrust law in the EU and the US. Similar to Western antitrust laws the Chinese law provides for a substantive test of the impact of M&A or anticompetitive conduct on competition and consumers. However, contrary to Western antitrust laws the Chinese AML explicitly also allows for the inclusion of national economic development and 'national interest' in the assessment of a merger or antitrust case.<sup>18</sup> Thus, the Chinese law "formally leaves the door open to industrial policy considerations in the substantive assessment of any case dealt with by the antitrust authorities" (Mariniello 2013:

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<sup>18</sup> National interest is not an exceptional instance requiring special treatment, as for example in the EU merger control. "It is rather one of the main elements to be considered when assessing the impact of a merger or an antitrust case (Mariniello 2013: 5).

5).<sup>19</sup> Recently there have been increased complaints that this possibility has actually been used by antitrust authorities to discriminate foreign-owned companies.

Since the introduction of the AML, there has been a constant increase in enforcement activity by the Chinese antitrust authorities. Available information on merger control cases decided between 2008 and mid-2013 indicates that MOFCOM may indeed have asymmetrically targeted foreign companies, while favouring domestic players. In several instances MOFCOM has authorised mergers conditional on behavioural remedies that appear to protect domestic competitors (particular SOEs) instead of protecting competition (Mariniello 2013). There is also evidence that M&A regulation is not uniformly applied across firms with different ownership structures. There is a lack of enforcement of notification obligations for domestic deals particularly those involving SOEs. “Chinese merger control does not seem to really apply to SOEs” (ibid.: 9).

By contrast, Mariniello (2013) did not find any indication that antitrust control, which is the responsibility of NDRC and SAIC, has been used to favour domestic players for the years from 2008 to 2013. There are complaints that this might have changed more recently, however. Since 2013 the NDRC has drastically stepped up the number of pricing investigations against foreign firms in key industries. In particular, there have been numerous investigations against major Japanese and European automobile companies accused of price-fixing and monopolistic conduct that have led to record fines being imposed on these firms. Related to these cases, Western media and business associations have increasingly criticised NDRC, and Chinese anti-trust authorities more generally, of targeting foreign companies in a discriminatory manner and using competition law to promote industrial policy objectives. In addition to the alleged targeting of foreign firms, Western firms and business associations have serious concerns about how investigations are conducted and decided. These concerns include *inter alia* lengthy time periods for merger reviews, the use of unusual conditions (not directly linked to antitrust concerns) for clearing mergers, strongly increasing fines determined on intransparent rules, and a lack of due process and (regulatory) transparency (for references see Grieger 2014).

So far, there have been only very few antitrust cases involving Chinese enterprises that have been reviewed by the EU antitrust authority, the European Commission’s Directorate-General for Competition. In single merger cases involving Chinese SOEs there have been complaints about overly burdensome administrative requirements. Indeed, in these cases there have been very extensive investigations by the Directorate-General for Competition into the governance system of Chinese SOEs. These investigations aimed at answering the question whether the SOE involved can be considered as having independent decision-making power (in which case it would be treated as a separate enterprise under EU law) or

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<sup>19</sup> Three institutions are in charge of implementing competition policy in China. The Ministry of Commerce (MOFCOM) is in charge of regulating mergers and acquisitions. The National Development Reform Commission (NDRC) is responsible for abuses of dominant market position and anti-competitive agreements directly related to pricing issues. And the State Administration for Industry and Commerce (SAIC) is responsible for abuses related to non-pricing issues.

whether this power lies with an entity above them, such as the State-owned Assets Supervision and Administration Commission (SASAC). Depending on the answer to this question the SOEs had to be treated as single entity or as part of a larger enterprise involving several or all SOEs enterprises (e.g., all SOEs under supervision of the SASAC) – a decision that may have important procedural as well substantive implications (for details see Zhang 2012).<sup>20</sup> In the end all the mergers involving Chinese SOEs were acquitted by the Directorate-General for Competition, even though it did not make a final decision on the single-entity question.

### 2.3 Cross-cutting problems

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Before closing this Section on the barriers to FDI in China and the EU it is useful to briefly discuss on two cross-cutting problems that are of great importance for understanding the barriers foreign investors in China face, both pre-entry and post-entry, and that repeatedly been touched upon in the previous subsections – the particular importance of state-owned enterprises in the Chinese economy and the weakness of China’s judicial review and law enforcement system.

#### *State-owned enterprises*

A source of widespread concerns of Western firms and policy-makers that runs through several of the issues already mentioned is the role of state-owned enterprises (SOEs) in the Chinese economy. Chinese SOEs are still playing, and are expected to continue to play, an important and often a dominant role in the Chinese economy. In several industries SOEs are the main competitors and sometimes also the main cooperation partners of European investors. At the same time SOEs are also “important to the country’s outward investment strategy, and have played a leading role in shaping it” (Zhang 2015).

China’s SOEs enjoy favoured access to many essential economic inputs such as land, finance, energy resources and infrastructures, and they have substantial market power in input markets for others such as minerals. Leading SOEs benefit from preferential policies and practices aimed at developing bigger and stronger national champions. In various economic policy fields they are frequently favoured not only over foreign invested firms but also over privately-owned Chinese firms. Examples mentioned above include the fields of public procurement and competition policy.

SOEs are not only favoured objects of many public policies or administrative processes, however, but may themselves be the subjects of (effective) discrimination of foreign investors. Due to their dominant or even monopolistic position in many industries, procurement decision of SOEs, for example, may have a decisive impact on business prospect of foreign-owned firms. In addition, some SOEs have been delegated, *de facto* or formally, with

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<sup>20</sup> The importance of the single-entity issue for the application of EU competition is not specific to Chinese SOEs but applies equally to SOEs from Europe or anywhere in the world.

authority to regulate certain aspects of an industry, such as issuing licenses or charging fees, even though they also act as a competitor in that industry. There have been concerns that SOEs misuse their privileged positions to favour national firms over foreign invested firms in their procurement or their quasi regulatory decisions (Miner and Hufbauer 2015).

Many of the anxieties related to Chinese firms investing in Europe are also directly related to the dominant position of Chinese SOEs. The role of SOEs (and Chinese sovereign wealth funds (SWF)) as the major players in Chinese outward FDI and the alleged opaqueness of their intentions have increased concerns among European experts and officials about problems of national security and unfair competition by these firms that led to repeated calls for more stringent regulations such as an amendment of national security review policies at the level of the EU and its member states (see above; also see He and Wang 2014; Nicolas 2014). While there has not been a single case where Chinese investments in the EU have been prohibited on the basis of national or European security yet, some European and Chinese observers see the risk of an increasing protectionist climate inside the EU (Nicolas 2014). As mentioned above, European investments by Chinese SOEs have also been at the centre of some recent EU merger control cases. While the respective mergers have been cleared by the EU competition authority, the opaqueness of SOEs governance structures and of their intentions may lead to serious conflict in future merger cases.<sup>21</sup> Already now, Chinese SOEs doing business in Europe feel that they are discriminated by being subject to particularly burdensome administrative requirements, including the required provision of documents issued by the Chinese State Council or the State-owned Assets Supervision and Administration Commission (SASAC), both at the level of the EU (see above) and in particular member states (for the case of Germany see CHKD 2014). The Chinese government and Chinese SOEs themselves consider this treatment as an inappropriate discrimination of Chinese SOEs and as inconsistent with the current state of the market economy and of SOEs in China (ibid).

#### *Judicial review and law enforcement*

Many of the investment barrier problems discussed above have in common that they are aggravated by the deficiencies of the Chinese court and law enforcement system. Even in fields where China's laws and regulations are largely up to international standards, as in the field of patent protection, the lack of an effective enforcement of these rules by courts is generally a source of great concern for European investors. Often there is a large gap between the written laws and regulations on the one hand and their application and enforcement on the other (European Commission 2013).

Generally European investors "feel that recourse to judicial remedies in China is not sufficient" and do not have confidence in the legal system to protect their rights as investors (European Commission 2013: 14). They criticise that the system is lacking transparency and

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<sup>21</sup> Remember that with respect to Chinese SOEs, the European Commission (DG for Competition) has not yet taken a final decision on the 'single-entity question'.

consistency both in the decision and in the judicial process itself (ibid.). The legal decision process is regarded as being subject to political pressure, both from SOEs and from administrative agencies at the central, provincial and local level (ibid.: 90, 97). Chinese courts were often reported to be usually not neutral towards foreign companies. Firms are often reluctant to start international investment arbitration proceedings against China because of the fear that this would deteriorate their relationship with the Chinese government and prevent them from doing business again in China, and that it would impact other investments that they already had made in China (ibid.).

There are in fact a number of related reasons for why courts in China cannot be expected to effectively enforce laws and regulations to protect foreign investors (see Bickenbach and Liu 2010; Clarke et al. 2008). There are a surprisingly large number of bodies that have the right or practical power to enact overlapping laws or regulations of varying binding effects and there is no effective system for enforcing jurisdictional or subject matter limitations on any particular body's law-making power. The legal system is unable to resolve conflicts between rules enacted by different levels or different arms of government. The possibility of court involvement cannot be generally assumed when a law is violated, and even if the courts become involved, their effectiveness is highly uncertain. Often other government agencies can ignore court decisions with impunity. Generally provisions in laws and regulations underlying government decisions are very vaguely formulated and authorities often rely on oral communication to convey specific conditions related to their decisions. As a consequence, it is often very difficult for foreign investors to provide evidence for inappropriate treatment by public authorities (US Chamber of Commerce 2012).

Probably the most important reason for the deficiencies of law enforcement in China is the fact that China's courts are not independent of the government. Courts are subject to Party supervision and are expected to align with the underlying policies of the Party. The powers to appoint and to dismiss a court's leadership rest with governments or Communist Party organisations at the same administrative level.<sup>22</sup> This makes it very hard for courts to take decisions that are against the wishes of governments, and it allows government agencies to influence courts, or to ignore their decisions, in order to accommodate the interests of SOEs or other companies with strong political relationships. Another reason for the lack of efficient application and enforcement of laws is the generally low level of legal training and competence of judges who often lack the sophistication to understand complex commercial disputes (Clarke et al. 2008; Trebilcock and Leng 2006). For all these reasons courts in China do not have the power necessary to constrain government's decision-making power and to provide effective protection against government expropriation of investments.

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<sup>22</sup> Local governments also control court finances, material supplies and welfare benefits for court officials (Clarke et al. 2008).



### 3 Prospects of a successful conclusion of the negotiations

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On the background described in the previous sections, both China and the EU have good reasons to pursue a comprehensive bilateral investment agreement and to conclude negotiations within a reasonable time frame.<sup>23</sup> Although the general objectives of both parties seem to be broadly compatible with each other in principle, there are also several sources of potential disagreement. This concluding section addresses a selected number of small and large obstacles that will have to be overcome in order to reach a meaningful agreement acceptable for both sides.

#### *Scope of market access / pre-entry provisions*

A critical part of the negotiations is the intended inclusion of market access rules into the agreement. China has traditionally refused to include any (significant) provisions related to the establishment of investments into its BITs, thus preserving its right to regulate the entry of foreign investments at will. Accordingly none of the existing BITs between China and EU member states contains any such provisions.<sup>24</sup> The EU has made it very clear, however, that market access provisions would be an integral part of any future investment agreements they are willing to sign with China (Berger 2013c). More specifically the EU is now urging to stipulate a negative list approach granting pre-entry national treatment to foreign investments in all sectors not included in the list.<sup>25</sup> While China seems to be willing to accept a negative list approach, there are likely to be substantial differences between China and the EU with respect to the scope of the list itself and of the commitment to be made with respect to foreign investments in sectors not included in the list (Zhang 2015). China is likely to favour a more cautious and limited approach including, e.g., a long negative list and the exemption of pre-entry provisions from international dispute settlement arrangements. The EU, by contrast, will push for a more 'symmetric' liberalisation of access which, given the fact that the EU is already much more open to foreign (including Chinese) investments, would imply a rather short negative list. In addition, the EU would like to extend international dispute settlement to any substantial pre- and post-entry provisions of the agreement (for more on this see below).

All this is not to say that China does not have its own interest in opening markets for foreign investments. Given the strong increase of Chinese FDI in Europe, China now has an

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<sup>23</sup> Ongoing negotiations on a BIT between China and the US had been launched in 2008. They were put to a halt in 2009 and resumed in 2012. The BIT between China and Canada was signed in 2012 after about a decade of negotiations.

<sup>24</sup> By including the terms "establishment" and "admission" in the list of investments activities included in the most favoured nations clause, China's most recent investment agreements with Canada and with Japan and Korea do include small steps towards investment liberalisation, however (Berger 2013b).

<sup>25</sup> A similar approach is followed by the US in its ongoing negotiations on a BIT with China.

obvious interest in ensuring that European markets will continue to be open for Chinese investments and that they are not going to be subject to discrimination (Król 2013). While Europe's markets are currently among the most open in the world for Chinese investments, Chinese investments have increasingly been regarded with suspicion in recent years by a growing number of European observers and decision-makers. A good EU-China investment agreement that also opens new market access in China helps to disarm those in Europe that want to see a hardened EU stance on Chinese FDI inflows (Król 2013). At the same time China should, at its current level of development, also have a strong own interest in dismantling restrictions on FDI inflows (World Bank 2012). In fact, the reform-minded Chinese leadership is thinking of (unilaterally) introducing a fundamental change towards a more liberal foreign investment regime including the establishment of a negative list system (Zhang 2015). As mentioned above, China is currently already experimenting with such a system in the four FTZs of Shanghai, Guangdong, Tianjin and Fujian. These changes are not undisputed among Chinese leaders, however. An EU-China investment agreement could do much to help reform-minded Chinese leaders to push and commit to such a change of China's FDI system (Zhang 2015).

A closely related issue that may also lead to conflict in negotiations is the potential inclusion of restrictions on the design of national security reviews in both Europe and China. While neither side will dispute the right of the other side to take measures it considers necessary for the protection of its essential security interests, both sides should also have an interest in preventing that excessively wide definitions of national security thwart the positive effects of the provisions stipulated to improve market access of foreign investments. Recently both sides have expressed concerns about an (alleged) extension and tightening of the national security reviews by the other side (see Section 2.1). Whether and how these problems should be addressed in the bilateral investment agreement currently negotiated remains an open question.

Another issue that has been linked by the Chinese government to the general question of market access of investments is that of granting of visas and working permits for Chinese nationals (European Commission 2013). China has raised concerns about an alleged tightening by EU member states of visa policies for Chinese nationals engaging in activities associated with Chinese investments in Europe (notably towards inter-corporate transferees). Existing BITs between EU member states and China include mostly rather vague best endeavour language on the issue (ibid.). The recently signed trilateral investment agreement between China, Japan and Korea as well as the BIT between China and Canada contain (slightly) more far-reaching provisions on the issue which could possibly be taken as a basis for negotiations on the issue between China and the EU.<sup>26</sup>

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<sup>26</sup> The *BIT between China and Germany* (Article 2 (4)), for example, reads: "Subject to its laws and regulations, either Contracting Party shall give sympathetic consideration to applications for obtaining visas and working permits to nationals of the other Contracting Party engaging in activities associated with investments made in the territory of that Contracting Party". By contrast, according to Article 8 of the *investment agreement between China, Japan and Korea*, contracting parties "shall endeavour, to the extent possible, in accordance with its applicable laws and regulations, to facilitate the procedures

### *Post-entry provisions*

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. This has also been true for the twenty-six existing BITs between China and EU member states. The level of protection provided to foreign investments differs substantially between individual BITs (and thus EU member states), however. For both sides, one of the main aims of the negotiated investment agreement is thus to replace this patchwork of different regulations and different levels of protection by a uniform framework applying to all EU member states. The new EU-China agreement will not be limited to harmonizing the post-entry provision of the different treaties, however, but is clearly expected to go far beyond the level and the scope of protection provided by the existing BITs between China and EU member states. In fact, with respect to a number of important issues, the provisions stipulated in China's more recent investment treaties, in particular the bilateral treaty with Canada and the trilateral treaty with Japan and Korea, already do go significantly beyond the corresponding provisions in China's BITs with EU member states. In several cases these provisions may thus serve as a reference point for the EU-China negotiations. In other cases the expectations and demands of the EU are (as in the case of market access liberalisation) likely to go substantially beyond the provisions of these contracts and possibly even beyond what China is currently willing to accept.

Probably the most important demand of the EU with respect to the extension of post-entry protection relates to a less restrictive and more symmetric approach to the national treatment standard. BITs between China and EU member states usually include a provision (generally a protocol) that permits China to maintain *existing* laws and regulations towards foreign investors that are incompatible with national treatment. In these cases China only agrees not to increase discriminatory treatment and promises to progressively remove non-conforming measures (Berger 2013b). While such provisions are also included in China's more recent BITs with Canada and with Korea and Japan, the EU is likely to demand a clearer commitment to the national treatment standard with respect to post-entry treatment but also with respect to the pre-entry treatment of European investors (see above).

Specific provisions that are included in China's more recent treaties and that may be adopted, in one form or another, into the EU-China agreement include, *inter alia*, (i) transparency requirements regarding the publication of investment-related laws and regulations and administrative rulings and judicial decisions of general application, (ii) the

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for the entry, sojourn and residence of natural persons of another Contracting Party who wish to enter the territory of the former Contracting Party and remain therein for the purpose of conducting business activities in connection with investments". And Article 7 (3) of the *BIT between China and Canada* stipulates: "Subject to its laws, regulations and policies relating to the entry and sojourn of non-citizens, a Contracting Party shall permit natural persons who have the citizenship or status of permanent resident of the other Contracting Party and are employed by any enterprise that is a covered investment of an investor, or a subsidiary or affiliate thereof, to enter and remain temporarily in its territory in a capacity that is managerial, executive or that requires specialized knowledge."

explicit prohibition of performance requirements (and the incorporation of the relevant provision of the WTO agreement on an Trade Related Investment Measures (TRIMs), and (iii) specific provision on the protection of IPRs. In addition, China's trilateral investment agreement with Japan and Korea contains a provision (in Article 23) that seeks to ensure that contracting parties will not relax justified environmental measures to encourage investments by investors from other contracting partners. The EU may want to incorporate a similar provision into its agreement with China and extend it to the (likely) more disputed cases of labour legislation and standards (as well as laws aimed at protecting and promoting cultural diversity) (European Commission 2013).

In light of the problems and concerns addressed in Section 2.2 the EU may in addition be interested in negotiating specific provisions on public procurement. Here the main aims of the EU would be to clearly define the conditions under which foreign-invested firms in China should be treated as domestic firms in public procurement and to encourage China to take the necessary steps to finally become member of the WTO agreement on government procurement (GPA).

#### *Treatment of SOEs*

Another challenge to the EU-China negotiations relates to the regulation and treatment of SOEs. The EU Commission has made clear that the investment agreement should address and remedy the unfair advantages enjoyed by Chinese SOEs. Privileges of and subsidies to Chinese SOEs do not only discriminate and disadvantage EU companies investing in China but may also give SOEs investing in Europe an unfair advantage over their competitors on European markets (European Commission 2013). Thus the EU has a clear interest in including provisions that limit the numerous public policies and administrative measures favouring SOEs. The same is true for provisions that preclude discriminatory behaviour by SOEs themselves including, but not limited to, all circumstances in which SOEs have been delegated government authority (such as issuing licenses). The EU is also very likely to call for greater transparency with regard to SOEs. Transparency requirements may include *inter alia* the timely publication of financial accounts according to international standards, the disclosure of leading managers' past and present connections to government offices, the publication of any exemptions of SOEs from any measure, regulation or law, and the disclosure of any tax preferences or subsidies for any SOEs (for these and related suggestions see Miner and Hufbauer 2015).

In principle, clear standards with respect to SOEs may not only be in the interest of European investors but may also be in China's interest. They may help rectify misinterpretations and prejudices about SOEs among European decision makers thus contributing to a fair, equitable and non-politicized treatment of Chinese SOEs' investment in Europe in general and with respect to the application of competition law (merger controls) and national security reviews in particular. In addition, it may also help facilitate reform of SOEs in China (He and Wang 2014). Still, it will certainly not be easy for China and the EU to find a common position on this issue.

*Investor-state dispute settlement (ISDS)*

Potential conflicts on an investment agreement between China and the EU may also arise from potential disagreements as to the scope and the specific design or implementation of an international investor-state dispute settlement mechanism.

Since the late-1990s, Beijing has been negotiating BITs that contain comprehensive investor-state dispute settlement provisions. As China's existing BITs, including those with EU member states, do not include any substantive provisions on market access, China's commitments to investor-state arbitration in these BITs only relate to the post-entry treatment of foreign investors. With respect to the comprehensive EU-China investment agreement currently under negotiation, it seems to be clear that China is *not* opposed to ISDS covering traditional post-entry protection. China should therefore be willing to accept the approach chosen by the EU and Canada in their recent Comprehensive Economic and Trade Agreement (CETA), where investment arbitration is limited to the post-entry phase (Berger and Skovgaard Poulsen 2015). Problems will arise, however, if the EU will, in light of the weakness of law enforcement in China (see Section 2.3), insist on extending ISDS to pre-entry issues. In fact, parallel investment treaty talks between China and the US have been difficult, as China has been very hesitant about having investor-state arbitration over pre-entry issues (Berger and Skovgaard Poulsen 2015).

Additional problems with respect to ISDS may result from the EU's ambitious plans to reform the traditional ISDS system. In the context of the ongoing TTIP negotiations between the US and the EU, the issue of ISDS has produced a polarizing debate within the EU. The current practise of ISDS mechanism has been heavily criticized by several civil society organisations in particular. Against this background the European Commission has recently (September 2015) proposed a "new and transparent system for resolving disputes between investors and states – the Investment Court System" that is supposed to replace the existing ISDS mechanisms in all ongoing and future EU investment negotiations (including the TTIP) (see European Commission 2015a; 2015b). Main elements of the proposed reform include:

- (i) A new balance between the protection of investments and the protection of the right of governments to regulate in the public interest: Future investment agreements need to ensure that the goal of protecting and encouraging foreign investments does not affect the ability of the EU and its member states to pursue legitimate public policy objectives. This includes providing clear definitions of key concepts like 'fair and equitable treatment' and 'indirect expropriation', and excluding claims against legitimate public policy concerns (European Commission 2015b).
- (ii) A public Investment Court System composed of a first instance *Investment Tribunal* and an *Appeal Tribunal*: Arbitral tribunals would operate more like traditional courts and access to an appeal system would be guaranteed. Judges for both Tribunals would be appointed in advance and on permanent basis. They would be subject to stringent technical and legal qualifications and strict ethical requirements. Judges hearing individual disputes would be allocated randomly, so disputing parties would have no

influence on the selection of judges for a particular case. Full mandatory transparency of the arbitration process would be guaranteed, making all documents and decisions publicly available and making all hearings open to the public. To avoid frivolous and unfounded claims, the *loser pays principle* and rules ensuring the early dismissal of claims would be introduced.<sup>27</sup>

First efforts related to the implementation of the first set of reform elements, such as a clear definition of ‘indirect expropriation’ have already been included in the recent trade agreement between the EU and Canada (CETA) but also in the recent China-Canada BIT. It can be expected that China has an interest to also include such a definition in the EU-China agreement and that it shares the objective of protection of the governments’ right to regulate in the public interest. Agreeing on the second set of ISDS reform elements, those directly relating to the establishment of a new public Investment Court System is likely to be much more difficult, however.

Finding a compromise on this issue will be further complicated by the fact that the EU’s main objective in proposing the new Investment Court System is rather the TTIP agreement with the US (though it should also be included in all future investment agreements signed by the EU). The further development of the proposal is thus expected to be determined mainly by the EU’s negotiations with the US rather than those with China. This is just one example of the complex strategic considerations that result from the contemporaneity of the negotiations on three important bilateral agreements – TTIP and the two bilateral investment agreements between China and the US and China and the EU – and whose analysis is clearly beyond the scope of this policy paper.

We therefore finish with some more basic conclusions. Both China and the EU have good reasons to negotiate and conclude a comprehensive bilateral investment agreement promoting and protecting mutual investment. The starting position for these negotiations is characterised by strong asymmetries. In Europe markets are much more open to foreign investments and the discriminatory treatment of these investments is much less prevalent in the EU than in China. It is therefore only natural that a comprehensive investment agreement will demand more ‘concessions’ and more far-reaching reforms from China than from the EU and its member states. This should be acceptable to Chinese leaders, if they recognise that reforms towards a more liberal FDI regime, further reforms of Chinese SOEs and a strengthening of law and contract enforcement (rule of law) are in China’s own best interest. On the other side Europeans will have to accept that not all reasonable and justified reform demands can or will be met by a single agreement. Some issues have to be dealt with by applying less ambitious transitional rules (Li 2014) and some will have to be left to other bilateral or multilateral agreements including a possible future EU-China free trade agree-

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<sup>27</sup> For the medium term the EU Commission proposes to go even further and work, together with other countries, on setting up one permanent International Investment Court that would, over time, replace all investment dispute resolution mechanisms provided by bilateral or multilateral trade and investment treaties (European Commission 2015a).



ment. Still, with respect to several key issues, most notably the liberalisation of market access and the less restrictive and more symmetric implementation of the national treatment standards, the investment agreement under negotiation must be substantially more comprehensive than China's recent BITs with other developed countries. Given the conflict potentials sketched above negotiating such an agreement will not be an easy task and will take its time. And it will take even longer before the formal rules of such an agreement will be fully implemented and before the adaptation of informal norms and codes of conduct necessary for an effective functioning of the formal rules will come about. Still, a good agreement will be worth the effort.

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## Appendix:

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### A1 Stylised facts: EU-China bilateral FDI flows

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Compared to the intensive trade relations between the EU and China, bilateral investments flows between China and the EU have been relatively low (Table A1). This is true particularly from a European perspective, i.e., when taking total EU inflows and outflows as the basis of comparison.

China's direct investments into the EU have increased substantially in recent years and reached €8.4 billion in 2012 (up from €0.4 billion in 2010 and €4.4 billion in 2011). Still their share in total non-EU FDI inflows to the EU-27 was only 2.7% in 2012 (up from 0.2% in 2010 and 1.0% in 2011).<sup>28</sup> By comparison, goods imports from China accounted for about 16-19% of EU members states' total goods imports in recent years. As a share of total Chinese FDI outflows, Chinese investments in the EU amounted to 12.3% in 2012 (up from 8.2% in 2011), while goods exports to the EU accounted for about 18.2% of total Chinese goods exports in 2012 (down from 21.5% in 2011).

European direct investment in China increased strongly from €3.9 billion in 2004 to €16.7 billion in 2011 but have been stagnating more recently (amounting to €16.3 billion in 2012 and €17.1 billion in 2013). As a percentage of EU member states' total direct investments outside the EU, their investments in China reached a temporary high of 5.1% in 2012 but were usually close to 3.5% in recent years (2010, 2011, 2013). By comparison, EU member states' goods exports to China amounted to about 8.5% of their total goods exports to countries outside the EU. While the EU's direct investments into China are thus still low compared to the EU's total outward FDI, the EU is one of the largest FDI providers to China.<sup>29</sup> Taken together, the EU member states accounted for about 17 to 19% of total Chinese FDI inflows in recent years (2011 to 2013). From a Chinese perspective the EU's role a source of inward FDI is thus much larger than its role as a source of goods imports. Since 2004, the Chinese goods imports from the EU fluctuated around 10-11% of total Chinese goods imports only.

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<sup>28</sup> Data on Chinese FDI inflows and outflows are not only quite volatile between individual years but they also differ substantially between different sources. The data used here are from Eurostat (2014) and European Commission (2015c). As data from most other sources they tend to underestimate Chinese FDI, as a substantial share of Chinese outward and inward FDI may be routed via Hong Kong or other third countries.

<sup>29</sup> Apart from the EU other large investors in China are Taiwan, Hong Kong, the US and Japan.

**Table A1:**  
**EU-China Bilateral FDI and Trade flows, 2004–2013**

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
<b>FDI from China to EU ... in bn €</b>	0.5	-0.1	2.2	0.8	-0.4	0.1	0.4	4.4	8.4	-
... as % of total non-EU FDI to EU	0.9	-0.1	1.0	0.2	-0.2	0.0	0.2	1.0	2.7	-
... as % of total Chinese FDI outflows	11.8	-1.0	13.0	3.9	-1.0	0.1	0.7	8.2	12.3	-
<b>FDI from EU to China ... in bn €</b>	3.9	6.1	6.7	7.1	5.9	8.1	10.5	16.7	16.3	17.1
... as % of total EU FDI to non-EU	2.7	2.5	2.1	1.3	1.5	2.4	3.5	3.5	5.1	3.6
... as % of total Chinese FDI inflows	8.0	10.5	11.6	11.7	8.0	11.9	12.1	18.7	17.3	18.3
<b>Goods exports China to EU ... in bn €</b>	128.7	160.3	194.9	232.7	247.8	214.2	282.5	293.7	290.9	280.1
... as % of total EU goods imports from non-EU	12.5	13.5	14.3	16.1	15.7	17.4	18.5	17.0	16.2	16.5
... as % of total Chinese goods exports	27.0	26.2	25.3	26.1	25.5	24.9	23.7	21.5	18.2	16.8
<b>Goods exports EU to China ... in bn €</b>	48.4	51.7	63.7	71.8	78.3	82.4	113.4	136.4	144.2	148.2
... as % of total EU goods exports to non-EU	5.1	4.9	5.5	5.8	5.9	7.5	8.3	8.7	8.5	8.5
... as % of total Chinese goods imports	10.7	9.8	10.1	10.3	10.2	11.4	10.8	10.9	10.2	10.1

Note: EU = EU27 for 2004–2012, EU28 for 2013.

Source: European Commission (2015c) and Eurostat (2014).



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