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The Downstream Implications of the EU-China Investment Agreement: Lessons from Trade

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Following seven years of negotiations and 35 rounds of talks, the EU and China reached agreement in principle on the Comprehensive Agreement on Investment (CAI) in December 2020. This article argues that the omissions contained in the design of the CAI have important strategic consequences, and hence, the EU should refrain from proceeding fully with this agreement until more questions are answered and ambiguities are resolved.

An Incomplete Agreement

Following seven years of negotiations and 35 rounds of talks, the EU and China reached agreement in principle on the Comprehensive Agreement on Investment (CAI) in December 2020.¹ Reaction to the agreement has thus far focused on its substantive content, but its design is also likely to have significant long-term consequences for both partners. This article argues that the omissions contained in the design of the CAI have important strategic consequences, and hence, the EU should refrain from proceeding fully with this agreement until more questions are answered and ambiguities are resolved. By focusing on the potential consequences of these -absent elements, this article highlights the extent to which the CAI represents a ‘mixed bag’ from the EU perspective, providing some important economic advantages but also creating long-term vulnerabilities.

The CAI has been called ‘the most ambitious agreement that China has ever concluded with a third country.’² It includes provisions on market access, the elimination of quantitative restrictions, and progress on China’s restrictive joint venture requirements.³ The EU hopes that the agreement will improve transparency in terms of China’s subsidies to state owned enterprises (SOEs), a long standing issue at the World Trade Organization (WTO), and reduce requirements for EU investors to share intellectual property with their Chinese joint venture partners.⁴ But despite this emphasis on its positive aspects, what is notable about the CAI is that it is relatively incomplete. Investment protections are not included and will be subject to further negotiations.⁵ The agreement takes only meagre steps towards reciprocity and level playing field rules, whilst ‘[T]he draft agreement fails to comprehensively advance equal economic openness and clear, binding, rules.’⁶ Commitments in the agreement on labour rights remain vague, and the EU has also failed to secure an investment court system to resolve disputes. Instead, it will rely on state-to-state dispute settlement procedures.⁷ To fill in these gaps, future expansion of the agreement is built-in to the initial deal. In section VI, article 3 for example, there is a mechanism to discuss the missing elements in future negotiations:

‘The Parties agree to continue...their negotiations with a view to negotiate an agreement on investment protection and investment dispute settlement. In such negotiations the Parties shall work towards: a) state of the art provisions in the field of investment protection; b) state of the art

¹ European Commission, “EU and China Reach Agreement in Principle on Investment,” 2020, accessed January 27, 2021, https://ec.europa.eu/commission/presscorner/detail/en/ip_20_2541.

² European Commission, “Key Elements of the EU-China Comprehensive Agreement,” 2021, https://ec.europa.eu/commission/presscorner/detail/en/ip_20_2542.

³ China has traditionally placed limits on the equity of investors or required that Chinese partners own a majority interest.

⁴ European Commission, “Key Elements of the EU-China Comprehensive Agreement.”

⁵ Theresa Fallon, “The Strategic Implications of the China-EU Investment Deal,” *The Diplomat*, 2021, <https://thediplomat.com/2021/01/the-strategic-implications-of-the-china-eu-investment-deal/>.

⁶ . François Godement, Sławomir Dębski et al., “EU Should Not Rush Investment Deal with China,” *EU Observer*, 2021, <https://www.clingendael.org/publication/eu-should-not-rush-investment-deal-china>.

⁷ François Godement, Sławomir Dębski et al.

provisions in the field of investment dispute settlement...The Parties shall endeavour to complete such negotiations within 2 years of the signature of the present agreement.”⁸

What explains the relatively incomplete nature of the agreement and what are its likely consequences? Uncertainty over the future can play a crucial role in the design of such agreements and can lead participants to design relatively limited initial deals. Where they are uncertain about the operation and consequences of an agreement, they can limit its coverage by allowing details to be filled-in once they have discovered more information.⁹ This can help to explain why, despite the fact that international agreements exist to create predictable commitments, they nonetheless evolve over time.¹⁰ Such an incomplete approach can be more efficient because it allows the parties to adapt to new information. However, whilst this concern for efficiency may have played a role in the CAI, it is unlikely that the failure to reach a more comprehensive deal was due primarily to the uncertainty faced by experienced European and Chinese negotiators. Instead, there is reason to think that strategic factors may be more crucial, with important consequences for the future of the EU-China relationship.

Strategic Dynamics

Strategic considerations can drive agreement design even where an agreement is focused primarily on economic issues. For example, one of the parties may derive bargaining advantages from negotiating elements of the deal in subsequent stages.¹¹ If one of the parties anticipates a growing advantage in bargaining power compared to the other, then by delaying negotiation on key aspects to subsequent stages it can secure a more favourable deal than it is able to achieve immediately. It has long been recognized that contract design at the individual and firm level is an important factor in determining the downstream bargaining position of contracting parties.¹² This work highlights how the lack of clear delineation of rights, obligations, and enforcement mechanisms, as in the CAI, can lead to subsequent so-called ‘hostage taking’ of relation-specific investments.¹³ That is, one of the parties can use a threat to existing investments to gain leverage. There is also a well-established International Relations (IR) literature that highlights the ways in which incomplete international agreements present possibilities for exploitation

⁸ European Commission, “EU – China Comprehensive Agreement on Investment (CAI),” 2021, <https://trade.ec.europa.eu/doclib/press/index.cfm?id=2237>.

⁹ Barbara Koremenos, “Loosening the Ties That Bind: A Learning Model of Agreement Flexibility,” *International Organization* 55, no. 02 (2001): 289–325, <https://doi.org/doi:10.1162/00208180151140586>.

¹⁰ Yoram Z Haftel and Alexander Thompson, “When Do States Renegotiate Investment Agreements? The Impact of Arbitration,” *The Review of International Organizations* 13, no. 1 (2018): 25–48; Kenneth W Abbott and Duncan Snidal, “Hard and Soft Law in International Governance,” *International Organization* 54, no. 3 (2000): 421–56.

¹¹ A Cooley and H Spruyt, *Contracting States: Sovereign Transfers in International Relations* (Princeton University Press, 2009).

¹² Oliver E Williamson, “Credible Commitments: Using Hostages to Support Exchange,” *The American Economic Review* 73, no. 4 (1983): 519–40, <https://doi.org/10.2307/1816557>.

¹³ Ronald H Coase, “The Nature of the Firm,” *Economica* 4, no. 16 (1937): 386–405; Williamson, “Credible Commitments: Using Hostages to Support Exchange.”

more generally.¹⁴ There is no reason to suspect that these dynamics should not also be present in the EU-China investment relationship.

In fact, we have good reason to expect power dynamics to be an important factor in EU-China relations. By most objective economic measures such as GDP growth rates or share of world trade, China is a relatively rising power compared to the EU.¹⁵ This shifting power dynamic, in addition to the potential for hostage-taking, may explain at least in part why an incomplete agreement that leaves many important details to subsequent negotiation will be beneficial for China. That is, by delaying negotiations on subsequent elements of the agreement China may be able to utilise its relatively growing bargaining power (in this case a growing GDP and domestic market) and leverage over existing investments to secure a relatively more favourable outcome in future, particularly in an era when economic growth in developed countries remains sluggish. These power dynamics may also allow China to tie further progress in investment negotiations (something clearly desired by the EU) to cooperation in other issue areas such as whether the EU will continue to restrict the involvement of Huawei in European telecommunications infrastructure.¹⁶

Despite these risks, there are incentives pushing the EU towards rapid conclusion and implementation of the CAI. The strongest incentives result from competitive dynamics. Existing investment agreements such as that between China, Japan, and Korea, ratified in 2014, have provided competitor firms with an advantage when accessing the Chinese market. This is because the agreement aligns the investment standards of the three countries more closely and includes provisions on transparency and intellectual property.¹⁷ With the new US administration in place there is now also a greater prospect for a China-US investment agreement to be concluded in the near future. The EU, by concluding a deal now, may provide European firms with some first-mover advantages compared to US companies, particularly in the relatively inefficient Chinese services sector.¹⁸ However, the focus on these benefits may have obscured the broader long-term risks of an incomplete agreement in light of EU-China power dynamics.

Lessons from China's Trade Agreements

To see how these dynamics may play out in the case of the CAI, China's approach to the design and expansion of its regional trade agreements can provide some clues. Like the CAI, China's trade agreements have long been recognized for their relatively incomplete coverage of issue areas, limited levels

¹⁴ Cooley and Spruyt, *Contracting States: Sovereign Transfers in International Relations*; Stephen D Krasner, "State Power and the Structure of International Trade," *World Politics* 28, no. 03 (1976): 317–47; R W Stone, *Controlling Institutions: International Organizations and the Global Economy* (Cambridge University Press, 2011).

¹⁵ World Bank, "GDP (Current US\$) | Data," national accounts data, 2019, <https://data.worldbank.org/indicator/NY.GDP.MKTP.CD>.

¹⁶ Alexis Leggeri, "EU-China Investment Deal: Has China Revived Its European Diplomacy?," *The Diplomat*, 2020, <https://thediplomat.com/2020/12/eu-china-investment-deal-has-china-revived-its-european-diplomacy/>.

¹⁷ Sean Miner and Gary Clyde Hufbauer, "State-Owned Enterprises and Competition Policy: The US Perspective," *Toward a Us-China Investment Treaty*, no. February (2015): 16.

¹⁸ Miner and Hufbauer, 6.

of initial liberalization, and relatively weak dispute resolution mechanisms.¹⁹ They are also notable because the Chinese government has exhibited a clear preference for concluding agreements that do not remain limited but rather anticipate subsequent negotiations as a means of expanding the agreements over time.²⁰ For example, in China's very shallow trade agreement with Pakistan there are provisions that provide for further extension of the treaty at a later date under phase II of the agreement. This is analogous to the provisions in section VI, article 3 of the CAI.²¹ In practice this has meant that as Pakistan's dependence on China has grown, particularly in terms of key industries such as textiles, its leverage in subsequent trade negotiations and its ability to secure an improved deal has declined.²²

China's initially limited trade agreements have also often been accompanied by valuable up-front concessions on the part of China. In its negotiations with ASEAN for example, China provided a number of 'sweeteners'²³ to secure a deal. Take, for example, the 'Early Harvest Program' which protected agricultural sectors in ASEAN countries during the early phases of the agreement. It eliminated tariffs on agricultural products from China whilst reciprocal liberalization was not required on the part of less developed ASEAN members such as Cambodia, Myanmar, Laos, and Vietnam.²⁴ Here, China extended 'most favoured nation' status to ASEAN's newer members and gave them an extra 5 years to comply with the agreement. It also agreed to write-off debts owed by ASEAN's less developed states to China.²⁵ At first, these concessions are perhaps surprising given China's power advantage relative to ASEAN. Yet, they had the effect, alongside the initially limited agreements, to encourage China's partners to make investments in the trading relationship. These investments, because they are focused on the Chinese market, would be costly to transfer, withdraw, or re-purpose, should the agreement be repudiated by either party.²⁶ These up-front concessions, therefore, stimulate the creation of asymmetric dependence and thus a stronger eventual interest in continuation and expansion of the agreement. This in turn reduces the bargaining leverage of China's partners further and makes it more difficult for them to walk away from subsequent negotiations. We can see this subtle dependence forming in the Pakistan case as

¹⁹ Agata Antkiewicz and John Whalley, "China's New Regional Trade Agreements," in *China's Integration Into The World Economy* (World Scientific, 2011), 99–121; Fred C Bergsten, "China and Economic Integration in East Asia: Implications for the United States" (Peterson Institute for International Economics, 2007); Elaine S Kwei, "Chinese Trade Bilateralism: Politics Still in Command," in *Bilateral Trade Agreements in the Asia-Pacific* (Routledge, 2013), 133–55; Ka Zeng, "China's Free Trade Agreement Diplomacy," *The Chinese Journal of International Politics* 9, no. 3 (2016): 277–305; M. Sampson, "The Evolution of China's Regional Trade Agreements: Power Dynamics and the Future of the Asia-Pacific," *Pacific Review*, 2019, <https://doi.org/10.1080/09512748.2019.1660397>.

²⁰ Sampson, "The Evolution of China's Regional Trade Agreements: Power Dynamics and the Future of the Asia-Pacific."

²¹ Sampson.

²² Shahzad Paracha, "Government Warned against Signing Another FTA with China," *The Daily Times*, 2016, <http://dailytimes.com.pk/business/24-Jul-16/govt-warned-against-signing-another-fta-with-china>; FM Shakil, "China's Pakistan Investments a Double-Edged Sword - Asia Times," *Asia Times*, 2021, <https://asiatimes.com/2021/02/chinas-pakistan-investments-a-double-edged-sword/>.

²³ Alice D Ba, "China and Asean: Renavigating Relations for a 21st-Century Asia," *Asian Survey* 43, no. 4 (2003): 640, <https://doi.org/10.1525/as.2003.43.4.622>.

²⁴ Ba, 637.

²⁵ Ba, 637.

²⁶ Benjamin Klein, "Transaction Cost Determinants of "Unfair" Contractual Arrangements," *The American Economic Review*, 1980, 357; Williamson, "Credible Commitments: Using Hostages to Support Exchange," 522.

well, where a further expansion of the agreement has continued despite the growing objections of key business sectors in Pakistan that are fearful of increasing exposure to Chinese competition.²⁷

While the notion of China's 'debt-trap diplomacy' may be overblown, the way strategic considerations interplay with China's economic diplomacy and its incomplete approach to agreements more broadly can also be seen in its Belt and Road Initiative.²⁸ China's strategy of gradual expansion of limited agreements, its growing investments in Pakistan, and the increasing importance of the China-Pakistan economic corridor, has provided China with opportunities to implicitly link further economic cooperation to other issues areas such as security.²⁹ This can be seen in the growing strategic relationship between Pakistan and China that has run in parallel to closer economic cooperation following conclusion and subsequent expansion of the trade agreement since 2006.³⁰ This can also be seen in the inability of ASEAN to coordinate on the South China Sea issue, despite the importance of the issue to a number of its members. This problem has been exacerbated by ASEAN's growing level of dependence on trade with China following the initial trade agreement of 2003, which eventually culminated in the ASEAN-China Free Trade Area (ACFTA) in 2010.³¹

Implications for the EU

As with China's trade deals, the CAI was secured following some important up-front concessions on the part of China, particularly in relation to France and Germany, with the former securing benefits for its healthcare industry and the latter focusing on the Chinese electric vehicles sector.³² In these sectors, China committed to remove joint venture requirements for private hospitals and electric vehicles, respectively.³³ This is valuable because China has traditionally required multinational investors to form a business relationship with a Chinese company. This has implied less control for European investors and often increases the risk of technology transfer to Chinese firms (a particular concern in innovative sectors such as electric vehicles).³⁴ Investments in the automotive and health sectors constitute 28% and 5% of

²⁷ Paracha, "Government Warned against Signing Another FTA with China."

²⁸ Michael Sampson, Jue Wang, and Irma Mosquera Valderrama, "Trade, Tax, and Development Finance," in *Global Perspectives on China's Belt and Road Initiative*, ed. Florian Schneider, Asserting Agency through Regional Connectivity (Amsterdam University Press, 2021), 59–94, <https://doi.org/10.2307/j.ctv1dc9k7j.6>.

²⁹ M. Sampson, "Expanding Influence: China's Evolving Trade Agreements in the Asia-Pacific," *The Diplomat*, 2020, <https://thediplomat.com/2020/02/expanding-influence-chinas-evolving-trade-agreements-in-the-asia-pacific/>.

³⁰ Ananth Krishnan, "China and Pakistan Sign Military Deal amid Tensions with India," *The Hindu*, 2020, <https://www.thehindu.com/news/international/china-and-pakistan-sign-military-deal-amid-tensions-with-india/article33219358.ece>.

³¹ Linh Tong, "The ASEAN Crisis, Part 2: Why Can't ASEAN Agree on the South China Sea?," *The Diplomat*, 2016, <https://thediplomat.com/2016/12/the-asean-crisis-part-2-why-cant-asean-agree-on-the-south-china-sea/>.

³² François Godement, Sławomir Dębski et al., "EU Should Not Rush Investment Deal with China."

³³ Fallon, "The Strategic Implications of the China-EU Investment Deal."

³⁴ Kun Jiang et al., "China's Joint Venture Policy and the International Transfer of Technology," *VoxChina*, 2019, <http://www.voxchina.org/show-3-115.html>.

total EU investments in China respectively and so these concessions represent a potentially significant benefit for the EU.³⁵

As EU investments in China increase in these areas and beyond, there is likely to be growing pressure on the EU to maintain good relations with China across a range of issue areas even where there is fundamental disagreement. These dynamics may mean that the EU will become increasingly reluctant to criticise China on human rights or on the security situation in the South China Sea and Taiwan Strait. Compounding this error is the fact that, without rigorous enforcement and precise investor protections it is not yet clear that the agreement will fundamentally change the investment relationship.³⁶ Experience suggests that the long-term consequences of the CAI should therefore be at the forefront of EU thinking, particularly given the growing willingness of China to utilise economic integration as leverage in political disputes, as seen in the recent dispute with Australia.³⁷

Though the use of economic leverage in this way is not new, nor unique to China, it would be prudent for the EU to protect itself against this risk as much as possible. History and research suggests two practical mechanisms by which this can be achieved. First, the EU can ensure that any dependence of its politically salient industries on the Chinese market is minimized. Alternatively, it can ensure appropriate institutional safeguards are included in the initial agreement.³⁸ Since the approach of minimizing the dependence of key industries on the relationship with China would also minimize the advantages of the agreement to the EU in the first place, the second element becomes all the more crucial. The clear policy lesson for the EU from China's approach to trade is that this developing relationship should be supported by a strong and unambiguous institutional structure. The EU should therefore seek a more detailed agreement with more precise investor protections and dispute resolution mechanisms before full implementation of the CAI. Because competitive pressures are pushing the EU to implement the deal quickly, and because the issue of effective dispute resolution and stronger intellectual property protections are also concerns for the US, there is also scope for greater coordination with the US. This can help to limit the competitive 'race to the bottom' dynamics in relation to low quality investment agreements with China.³⁹

The Benefits of Structured Cooperation

The CAI provides the EU with some potentially important economic benefits in relation to key domestic industries, provided that the agreement can be effectively enforced. There are significant wins in terms of improved market access, elimination of restrictions, and on the relaxation of joint venture requirements. Strong and growing economic cooperation between the EU and China is undoubtedly a positive and

³⁵ European Commission, "EU and China Comprehensive Agreement on Investment Factsheet," 2020.

³⁶ François Godement, Sławomir Dębski et al., "EU Should Not Rush Investment Deal with China."

³⁷ "China Trade Dispute Cost Australia \$3 Billion in Lost Exports," Bloomberg, 2021, <https://www.bloomberg.com/news/articles/2021-01-21/china-trade-row-has-cost-australia-3-billion-in-lost-exports>.

³⁸ Cooley and Spruyt, *Contracting States: Sovereign Transfers in International Relations*, 9.

³⁹ Miner and Hufbauer, "State-Owned Enterprises and Competition Policy: The US Perspective," 12–13.

valuable development for both parties and the world economy more generally. However, this relationship will not remain static, and it is important to recognize how power dynamics and agreement design interact in ways that will have significant consequences for the future relationship. China's approach to trade and economic integration more broadly illustrates the ways in which cooperation can be a double-edged sword for the EU, providing significant potential benefits but also creating vulnerabilities. In the long-term, EU interests, and its relationship with China more generally, will benefit from cooperation that is supported by an institutional structure that is clear, comprehensive, and precise regarding the rights and obligations of the two parties, even if this requires some more difficult bargaining up-front. In particular, the ambiguity regarding investor protections and the resolution of disputes entailed by the CAI has the potential to undermine the benefits of the agreement and have a costly impact for EU investors. This in turn may undermine broader EU-China relations when such disputes do arise. From a long-term strategic perspective then, China's pattern of diplomacy in trade suggests that it would be beneficial for the EU to stall on full implementation of the CAI until a more comprehensive agreement is secured, even if this means sacrificing some short term economic gains.

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