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The EU-China CAI: An agreement whose time has passed?

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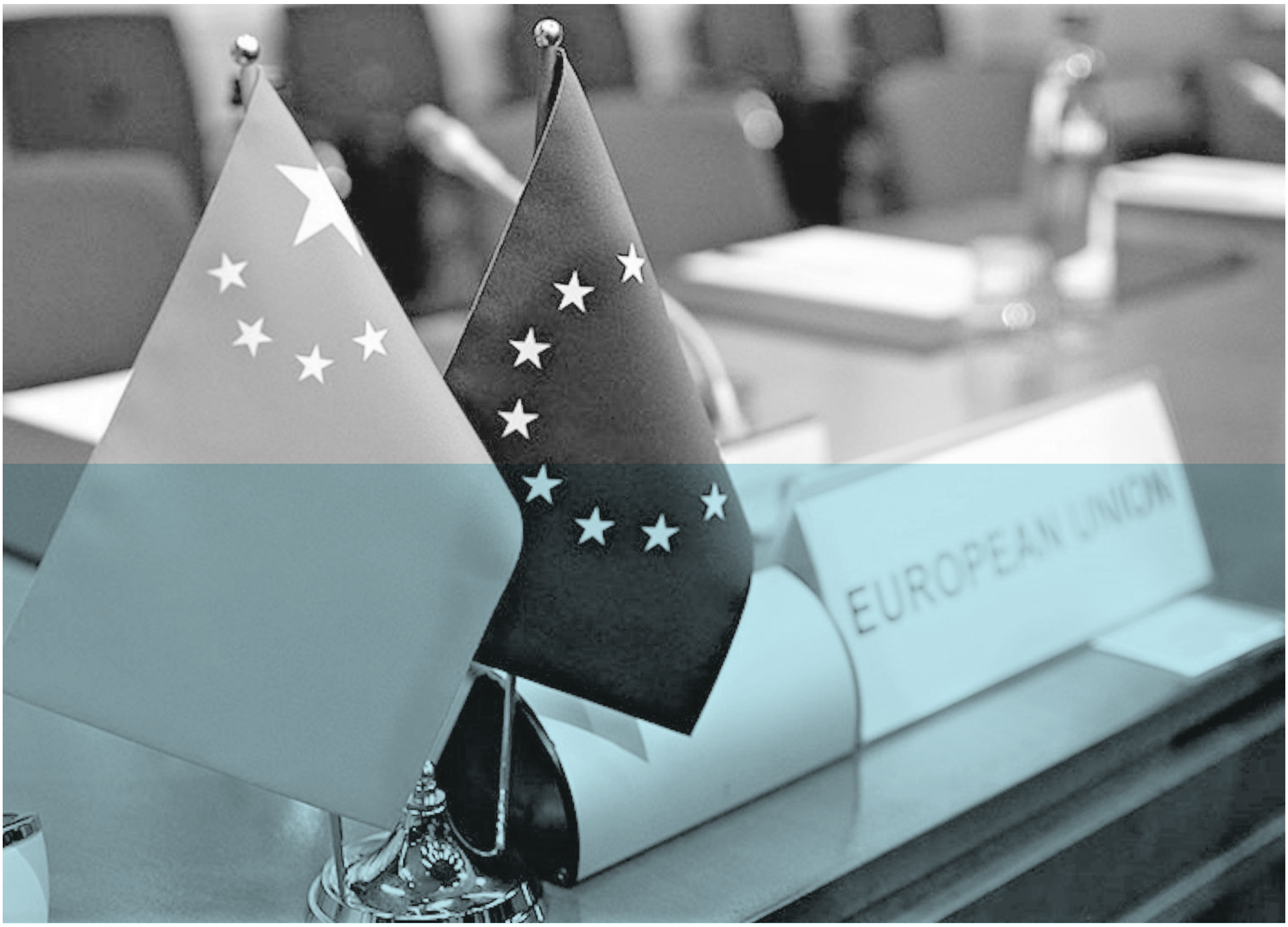

Introduction

When, in October 2013, the European Council urged the European Commission to negotiate an investment agreement with China, it stated its goals as "enhanced protection of EU investments in China and vice versa, improved legal certainty regarding the treatment of EU investors in China, reduction of barriers to investing in China and, as a result, increasing bilateral investment flows and improved access to the Chinese market." Negotiations, the directive continued, should conclude no later than two and a half years after they started.

Thirty-five rounds of negotiations and seven years later, an "in principle" agreement has emerged. Detailed annexes[1] were published in March 2021, allowing for greater scrutiny of the Comprehensive Agreement on Investment (CAI).

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To be clear, the CAI is not a trade agreement, although the trade relationship was important background for the negotiations. It is perhaps a one-of-a-kind deal aimed at balancing the existing asymmetric investment relationship. Chinese companies enjoy a far greater freedom to invest in Europe than EU companies do in China. This pre-existing asymmetry – arguably a testimony to the mishandling of past engagement with China – helps to explain the delay in reaching an agreement. China had little motive to address the imbalance.

The next step is ratification (or not) by the European Parliament. This process will shine a light on past, current, and desired future levels of economic engagement with China; the importance of China's economy to Europe; and future prospects for trade and investment with China vis-a-vis other regions. The ratification process will no doubt fuel a broader debate about the European Union's place in the world; its relationship with a regime whose approach is at odds with the espoused liberal values of the EU, and Europe's relationship with the United States, the provider of its security umbrella. In many ways, the existence of the CAI may be of greater importance than the agreement itself.

This paper explores the background to the CAI, the EU's asymmetric economic relationship with China, and in the context of China's two decades of phenomenal growth, the relatively modest economic interaction between the two parties. The paper then examines the prospect of the CAI rebalancing and deepening the relationship. It will then pose this challenging question: Given past economic interaction with China and China's recent geopolitical behavior, are deeper economic linkages sustainable or compatible?

Background

A changing geopolitical and diplomatic landscape

> References to "shared interests" and "deepening economic integration" in the communique from the 2012 EU-China summit reflect the optimistic mood that then existed.

In assessing the merits of the CAI, it is important to understand how the economic and geopolitical environment has changed during the negotiations. In particular, understanding other areas of economic engagement between China and the EU is crucial to ascertaining the evolving investment priorities and needs of both parties. It is not surprising that the geopolitical landscape has changed. References to "shared interests" and "deepening economic integration" in the communique from the 2012 EU-China summit reflect the optimistic mood that then existed.[2] China had an outsized role in driving global growth and was an increasingly important market for EU exports. There was no hint of the "strategic competition" or "differing values" that now accompany the relationship.

It is a different world now. Today, the agreement's ratification is being put forward as China continues its geographical expansion in the South China sea, the

Himalayan plateau, and the East China sea. China's weaponization of economic relationships to achieve geopolitical ends has intensified, with Australia as its most recent target. Global clothing companies eager to distance themselves from Xinjiang cotton are now suffering the state-media generated wrath of public opinion in China. The CAI now appears to have been conceived in an era of relative naivete towards China's rise.

A changing balance in economic power

China's economy has since grown by more than USD 6 trillion and now matches the size of the EU.

The economic situation has changed dramatically too. In 2012, the size of the EU's economy was USD 14.5 trillion, or 70% larger than China's USD 8.5 trillion. China's economy has since grown by more than USD 6 trillion and now matches the size of the EU – compounding at 7.2% to produce 74% nominal dollar growth between 2012 and 2020.[3] China's realized growth (on official numbers at least) was phenomenal on an absolute and a relative basis, its contribution to global growth was at its peak, and its prospects offered remarkable potential, at least for those with an inclination to extrapolate from the present into the future.

Meanwhile, the EU's economy has simply not grown in US dollar terms during the negotiation period. Furthermore, Brexit shrunk the EU's economy by about USD 2.8 trillion. The dramatic shift in the relative economic balance of power would have influenced the negotiations.

Trade remains imbalanced, with China's growth increasingly less import intensive

Although the EU economy remained almost unchanged in size between 2012 and 2020, China grew its exports to the EU by 35%. The EU also grew its exports to China – by 35% too in dollar terms – but from a lower base.

Yet the two economies' dramatically different growth rates did not rebalance the trade relationship in goods, as economic theory would suggest. The reality begs the question: Why? Although the EU economy remained almost unchanged in size between 2012 and 2020, China grew its exports to the EU by 35%, from USD 323 billion to USD 436 billion. The EU also grew its exports to China – by 35% too in dollar terms – but from a lower base of USD 170 billion to USD 230 billion. The marginal propensity of China to import from the EU (the growth in imports from the EU divided by the growth in GDP) was just 1%.

In contrast, during the same period EU exports to the United States grew by USD 78.5 billion – that's more than EU export growth to China. This growth took place even though the US economy grew by only USD 4.8 trillion (less than China's GDP growth). Thus, US growth was 65% more EU import intensive than China's growth.

The growing trade deficit in goods between the EU and China, from EUR 118 billion to EUR 183 billion, is indicative of China's closed market. This is not a function of a lack of treaties, agreements, or legal commitments, but rather of the statist-nationalistic economic structure of China, a non-market economy that prioritizes the power-enhancement of the Party-State in its trade policy.

Germany dominates EU-China trade – but its dependence on China is overstated

The pattern and importance of China trade is also very different for different EU countries. In 2020, of the total EUR 202 billion of EU goods exports to China, 48% were from Germany. Intriguingly, this sum accounted for only 2.9% of Germany's GDP. The sum of Italian goods exports to China was even smaller at only EUR 12.8 billion – that is 6.1% of extra-EU exports and less than 1% of GDP.[4]

When it comes to balancing values, the national interest, and the benefits from trade and investment with China, it is difficult for the EU to speak with one voice. Germany enjoys deeper trade integration with China than the bloc, although any claim to dependency is overstated. Along with Ireland and Finland, Germany is one of only three countries in the EU that enjoys a trade surplus with China.

Autos dominate EU-China links

The automotive industry is dominant in the EU-China economic relationship.

The automotive industry is dominant in the EU-China economic relationship. 'Machinery and vehicles' exports, predominantly from Germany, account for 50% of total exports (EUR 100 billion). The next largest exports are chemicals, at only EUR 30 billion.

Cars are a subsector of the broader vehicle category. Although German car makers now produce more cars in China than they do in Germany, China still accounts for 13% of car exports from the EU, the third largest market after the UK and USA. To circumvent high tariffs and avail themselves of cheap labor, German car makers have largely adopted a "made in China, for sale in China" approach.

It should be clear that there is no economic equivalence between offshore production and exports when it comes to the benefits that accrue to the EU. In the former case, the value added is in China, the employment is in China, wages and taxes are paid in China, and the profits could be repatriated (subject to capital controls and withholding taxes) or reinvested in China. In the case of domestic production for export, the value added is domestic and shared between domestic labor and capital; the taxes are paid at home. Off-shoring to a non-market economy does not necessarily enhance efficiency for mutual gain. On the contrary, it can result in institutionalized inefficiency, as non-market factors drive capital allocation and reciprocity does not emerge willingly.

China's shrinking vehicle market – and profitability too

Car manufacturing encapsulates the EU's China conundrum. Since the start of CAI negotiations, the China vehicle market (commercial and passenger cars combined) grew from 5.7 million units in 2005 to 18.4 million units in 2012. This 18% compound annual growth rate (CAGR) was exactly the kind of opportunity that motivated negotiations for the CAI. In the subsequent years through to 2017, the pace of market growth moderated to 8.5% CAGR, but that remained a significant expansion.[5]

In the period prior to the commencement of negotiations, however, the market size has shrunk, from a peak of 27.5 million units to 23.4 million units in 2020.

In the period prior to the commencement of negotiations, however, the market size has shrunk, from a peak of 27.5 million units to 23.4 million units in 2020. Furthermore, in the case of Volkswagen, its share of operating profits from its joint ventures has fallen from about EUR 6 billion in 2016 to EUR 4.4 billion in 2019. Profits fell further in 2020, to EUR 3.6 billion. German brands continue to do well, with China sales accounting for about 40% of German car sales in 2020.

But the stagnant market size begs two questions going forward. Are European companies well placed to capture the transition to electric vehicles (EV)? How large and profitable will the overall market become? Concessions and compromises in the CAI to secure better access and protection for car makers may come just when European fortunes in China's auto market are turning for the worse. Even if German auto makers adapt well to the EV market, China looks set to capture a greater share of the value added in batteries and related industries. As the car industry undergoes a state of flux, questions will emerge about the foresight exercised during the CAI negotiations.

Uncertainties: China's future growth, its import intensity, its geopolitical relationship with the EU, and the role of multinationals

Disappointing news from the auto industry is perhaps just the beginning. Official data shows China's GDP growth as slowing dramatically during the negotiation period. From 2003 to 2013, China recorded real GDP growth exceeding 10%. The rate has almost halved in recent years to about 6% – and there is considerable evidence that this figure has been over-stated by 1% to 2% per year.

As a percentage of GDP, trade has fallen to below the level China enjoyed prior to it joining the WTO in 2001.

Growth has also become investment intensive and driven in particular by real estate. In contrast, imports of goods and services in the last five years expanded by only 2% CAGR in nominal US dollar terms. As a percentage of GDP, trade has fallen to below the level China enjoyed prior to it joining the WTO in 2001. China's working age population is set to fall by 15 to 20% in the next two decades, and the growth of its capital stock is slowing. Add to this discouraging list the misallocation of investment for political rather than economic ends, and China's economic outlook becomes at best uncertain. Such uncertainty is doubly true when one considers the stated objectives of Chinese industrial policy: to wean China off its foreign dependency for technology. Policies aimed at autarky do not suggest a favorable environment for foreign companies operating in China nor those wishing to sell to China.

Amid this dulling of what was once the spark of the global economy, the European Commission is asking the European parliament to ratify the CAI.

Chinese foreign direct investment (FDI) in the EU

China's EUR 120 billion cumulative direct investment into the EU amounts to only 5.6% of China's total overseas direct investments.

Let us now consider China's investment in the EU. The numbers are not encouraging. According to the State Administration for Foreign Exchange (SAFE), China's stock of overseas direct investment amounted to USD 2.4 trillion at the end of 2020. That means China's EUR 120 billion cumulative direct investment into the EU amounts to only 5.6% of China's total overseas direct investments.

The shallow investment relationship and its macro-economic implications means that even future rapid growth will not move the needle from an EU-wide growth perspective.

When one considers that the stock of overall FDI into the EU has exceeded EUR 7 trillion, China's investment appears even smaller – about 1.5% of total investment. The shallow investment relationship and its macro-economic implications means that even future rapid growth will not move the needle from an EU-wide growth perspective. Of course, a large increase in in-bound FDI from China is potentially significant for individual EU countries, particularly smaller economies.

However, EU economies should also consider what increased investment from China may entail. Is it desirable for the EU to gain more investment, domestic or foreign? If so, is investment in the EU constrained by a lack of availability of domestic saving, or is it constrained by lower perceived returns on investment? Given the EU's existing open door to investment, why would the CAI prompt China to invest more in the EU than it does already? If domestic entrepreneurs are less than enthusiastic about investing in the EU, would Chinese companies find investments in Europe attractive? Is there extraneous non-economic rationale for such potential investments?

Investment into the EU has been soft for some time. In the years preceding the negotiations, gross fixed capital formation (investment) in the EU fell from 23.3% of GDP to a low of 19.7% in 2013. The investment rate has since recovered to 21.6% and is within the range of normality established in the 1990s. The European Central Bank has been extremely accommodative in its support of lending and investment by EU banks. EU purchases of government debt also eases fiscal constraints. With interest rates so low – negative across the yield curve for many – the issue is the demand for investment, not the availability of financing. China cannot solve this conundrum.

If based purely on economic grounds, it is hard to understand China's motivation for the CAI. Europe is already open to investment. Chinese companies enjoy lower costs and standards at home. Broadly speaking, tariffs into the EU are low. Companies with a competitive advantage have likely already invested. Capital looking to flee China for political reasons is unlikely to be deterred or induced by the CAI. On the other hand, state-guided investment is seldom determined by purely economic rationale.

State-owned or state-connected enterprises dominate China's outbound FDI. Whether acquiring stakes in critical national infrastructure, or technology companies with intellectual property, or investing in the media or academia for influence, the rationale is often as much geo-strategic as it is economic. One assumes that the EU's intention for the CAI is not to facilitate such actions. A more open environment for EU companies in China may not be worth the compromise.

EU FDI in China

Relative to its potential, EU exports to China have been dismal, growing just USD 60 billion while China's economy grew by USD 6.3 trillion.

From an EU perspective, better business prospects in China are the main rationale for the CAI. Relative to its potential, EU exports to China have been dismal, growing just USD 60 billion while China's economy grew by USD 6.3 trillion. Perhaps the biggest issue is the gulf between local laws, international treaties, and agreements for investments in China – and the practical reality on the ground.

China is in no way capital constrained. It seeks foreign investment only for its quality – and quality is defined by the intellectual property that comes with the investment.

China's savings rate is very high – about 45% of GDP if official statistics are to be believed. Despite running high levels of investment relative to GDP, China has had an excess of savings over investment every year since 1993, sometimes to the tune of 10% of GDP. In 2020, China savings ran to about USD 6.5 trillion. Quite simply, China is in no way capital constrained. It seeks foreign investment only for its quality – and quality is defined by the intellectual property that comes with the investment.

In 1980, China became a member of the World Intellectual Property Organization. Some 20 years later, it joined the WTO. As such, China is subject to the Agreement on Trade Related Aspects of Intellectual Property Rights, or TRIPS. In 1996, the United States and China also signed an agreement to protect intellectual property.

This long history of participation in international agreements has not dissipated China's tendency for forced technology transfer. China owes its leadership in high-speed rail to the transfer of IP from Siemens and other partners.[6] Similarly, as Airbus and Boeing compete to sell passenger aircraft to China, technology transfer remains a condition to keep the orders coming, while at the same time China embarked on its own passenger aircraft program.

Technology transfer makes FDI invaluable to China. Take away IP transfer and FDI serves little purpose in an economy that suffers from over-investment and declining returns on capital. Given China's track record on intellectual property protection (or lack of) and technology transfer, will the CAI be successful in enforcing protection where many other agreements have failed?

Yet there is one potential benefit to China that should not be overlooked – and that is to swell China's foreign exchange reserves, which in turn can support China's overseas expansion. Capital flight prompted by President Xi's anti-corruption crack-down accelerated from 2014 to 2015 as did SOE-led overseas investment, including for the Belt and Road Initiative. These twin outflows resulted in foreign exchange reserves falling from about USD 4 trillion to USD 3 trillion. This "going-out" policy to expand China's economic and geopolitical sphere of influence demonstrated that, in the absence of a large current account surplus, China's overseas ambitions required an alternative source of foreign exchange inflow and tighter controls over domestic capital outflows. To induce portfolio inflows, foreign access to Chinese capital markets were liberalized and domestic outbound capital controls tightened.

One incentive for China to complete the CAI was, therefore, to induce capital inflows from the EU to help finance state-directed overseas investment.

For China, an ideal situation has the EU bringing technology transfer with its direct investment, combined with portfolio investors buying minority, passive, and low yielding investments with foreign exchange that could be recycled into more Chinese investments overseas. Given the relative balance of economic power and growing concerns about China's politicization of the economic relationship, perhaps the bar for ratifying the CAI is set high.

The macroeconomic asymmetry

Tight capital controls in China hover over the two-way flow of investment between the EU and China.

Tight capital controls in China hover over the two-way flow of investment between the EU and China. Historically, these have applied to both inbound and outbound investment. Capital controls have afforded China degrees of freedom in monetary policy that would not exist with an open capital account. China has used the periodic relaxation and tightening of capital controls to manipulate its exchange rate; it relaxes outbound controls when the real exchange rate is deemed too high and tightens them when the exchange rate is under unwanted downward pressure. In contrast, the EU does not have capital controls in place. Be they companies or portfolio managers, EU investors are free to seek the best risk-adjusted returns available in the global economy.

If one accepts that China's vast savings were accumulated behind a bamboo curtain of capital controls and that state institutions exert control over capital allocation, the impossibility of a reciprocal agreement on international investment becomes clear. Capital controls can stop any outbound investment from China and all outbound investment must be approved by the Communist Party of China (CPC) before any agreement rules come into play. That first veto held by the CPC is critical.

Consequently, it may be more appropriate to refer to the CAI as a "transactional deal" rather than a "comprehensive agreement" based on the principle of equal access and the free movement of capital.

What does the deal offer?

Improvement in market access can be best described as incremental rather than transformational.

Initially, the objective of the CAI was to negotiate for market opening and greater protection for EU companies. The annexes provide details on the theoretical permissions that the CAI secures for EU and Chinese companies. There is incremental liberalization pertaining to ownership structures and market access in the automotive industry, specifically for electric vehicles, financial services and in healthcare provision. However, the improvement in market access can be best described as incremental rather than transformational.

It is important to note that, unsurprisingly, both countries retain the right to scrutinize in-bound FDI from a national security perspective. The EU's new FDI

It is important to note that, unsurprisingly, both countries retain the right to scrutinize in-bound FDI from a national security perspective.

screening process is fully operational. In January 2021, China's new measures for the national security review of FDI came into force. So, today any FDI could fall foul of the new measures depending on the prevailing appetite of the recipient country. Review processes for FDI were tightened as the CAI negotiations concluded.

It could be argued that a less dramatic but potentially important aspect of the CAI has been to lock-in the current level of market access and prevent back sliding. This is a modest goal that implies a distrust of existing commitments or an acknowledgement of their failure, a reflection of the reality of the current economic engagement with China.

Regarding SOEs, the CAI agrees to greater transparency concerning state subsidies. Should this be implemented, the information would provide useful insight into China's economic modus operandi. The CAI also seeks to ensure that SOEs do not discriminate in their sales and purchases and that they act in a commercial manner. Such a far-reaching commitment appears antithetical to the structure and operation of China's statist-mercantilist economy and it remains to be seen whether the words will be put to practice. On labor standards, China commits to "work towards" the implementation of International Labor Organization conventions, a commitment which contrasts sharply with what has been observed in China to date.

The agreement's chapter on investor protection is not concluded. A time frame of two years has been set for its completion. Current events are proving the need for investor protection. H&M and other users of cotton from China are the latest to experience the Chinese authorities' sway in inflaming public opinion against foreign businesses. If the CAI had been ratified and was operational today, would it enable H&M to seek compensation from the Chinese state?

If China can behave in such a way when the CAI is pending ratification – a time when it should be offering an incentive for collaboration – how will China behave after ratification?

If China can behave in such a way when the CAI is pending ratification – a time when it should be offering an incentive for collaboration – how will China behave after ratification? The demands placed upon multinational corporations to de-stigmatize Xinjiang cotton are the latest in a long line of politically motivated actions aimed at punishing less than compliant companies. The targeting of airlines that advertised services to 'Taiwan' and the National Basketball Association (NBA) are illustrative of China's willingness to impose economic costs on organizations that do not adhere to its political agenda. Given the systemic rivalry and the clash of political ideologies, can a treaty offer sufficient protection to foreign investors in China?

The road to ratification?

The question now facing EU policymakers is simultaneously complex and simple. Will the EU compromise its extolled intention to build a values-orientated, rules-based, multilateral trade policy in return for modest and incremental market access to China that may or may not manifest in practice? When the process began, it might have been less obvious that the agreement would entail a compromise in values. Today, it is indisputable. At the time, there may have been more reason to believe that theoretical agreements would be translated into practice. Accumulated experience suggests the opposite may be more likely.

Reasons to ratify the treaty may be geopolitical. China saw an opportunity to drive a perceived wedge between the EU and the United States. Europe saw an opportunity to establish a degree of strategic autonomy and demonstrate ability to strike a deal comparable to the United States' Phase One trade deal.

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This fleeting coincidence of wants – and Chancellor Angela Merkel's eagerness to see the deal conclude under her watch[7] – may have driven progress in the negotiations towards the in-principal conclusion. That moment of harmony passed quickly. The EU's reward for acquiescence is the targeting of its companies in China and sanctions against its parliamentarians and the MERICS think-tank.[8]

The long-term geopolitical considerations revolve around vital questions. What sort of relationship does the EU want with China? How does economic engagement help to achieve these goals? The CAI is likely to prompt a highly public debate in the EU around these issues. That may be the CAI's lasting legacy.

The proposed CAI may have helped to define Europe's international economic relationships for the foreseeable future – just not in the way that China intended.

A deep debate about China's recent behavior might spark some difficult conclusions: that economic dependence on China is sub-optimal and moderated economic engagement may suit Europe's long-term interests better. If a set of values do bind together the European Union, these values should define the EU's international economic policies and be applied to investment and trade agreements. Such a conclusion would not mean that seven years of negotiations were wasted. On the contrary, the proposed CAI may have helped to define Europe's international economic relationships for the foreseeable future – just not in the way that China intended.

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About the author

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Notes

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