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IMPACT ASSESSMENT REPORT ON THE EU-CHINA INVESTMENT RELATIONS

Accompanying the document

Recommendation for a Council Decision

authorising the opening of negotiations on an investment agreement between the European Union and the People's Republic of China

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BACKGROUND

1.1. A new comprehensive European investment policy

The Lisbon Treaty provides for the European Union to 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 confer exclusive competence to the European Union in the field of foreign direct investment.

The Commission Communication[1] of 3 March 2010 "*A strategy for smart, sustainable and inclusive growth – Europe 2020*" emphasises the need to build strategic relationships with emerging economies. Trade and investment are a crucial component of the triple growth objective of the Europe 2020 Strategy. The Commission Communication[2] of 7 July 2010 "*Towards a comprehensive European international investment policy*" identifies China as a potential partner for an investment agreement, given the shortcomings of the current legal framework and climate for investment between the EU and China.

While the relationship between FDI and economic growth and economic welfare is a complex one, on balance, both inward and outward investment have a positive impact on growth, competitiveness and employment. EU Member States make significant efforts to attract foreign investment. A study conducted in May 2010[3] for the EU estimated that the EU receives a net positive income from FDI with the rest of the world of around €75 billion per year.

In April 2010 the European Commission President José Manuel Barroso and Chinese Premier Wen Jiabao agreed to look into ways of deepening and enhancing the EU-China bilateral investment relationship. European Trade Commissioner Karel De Gucht and the Chinese Minister for Trade, Chen Deming agreed at the EU-China Joint Committee in May 2010 to launch a Joint EU-China Investment Taskforce to study the options for enhancing bilateral investment and evaluate the desirability and feasibility of potential negotiations of an EU-China investment agreement.

As a consequence of this mutual political intent and in order to guide next steps, this impact assessment analyses the underlying problems in the current EU-China investment relationship, the different options to address these and their respective impacts.

2. PROCEDURE AND CONSULTATION

2.1. Procedural issues

An Impact Assessment Steering Group (IASG) was set up in December 2010. The IASG met six times[4] until the final report submission to the board. A wide range of DGs and services took part in the IASG[5], with DG Trade as the lead service.

[1] Commission (2010a).
[2] Commission (2010c).
[3] Copenhagen Economics (2010).
[4] 16 December 2010 12 April 2011; 19 July 2011 7 February 2012, 18 April 2012, 22 May 2012
[5] The IASG included DG Agriculture and Rural Development, DG Budget, DG Climate Action, DG Competition, DG Development, DG Economic and Financial Affairs, DG Education and Culture, DG Employment, Social Affairs and Inclusion, DG Energy, DG Enterprise and Industry, DG Environment, DG

EU Member States were regularly informed in the context of the Joint EU-China investment taskforce, including at the Trade Policy Committee (Services and Investment). In addition, a special informal technical meeting with Member States on EU-China Trade and Investment relationship took place on 16 June 2011. The European Parliament was briefed on the process at a special session of the International Trade Committees China Working Group.

An external consultant (Copenhagen Economics) was retained in spring 2011 to support the work with key inputs, data and economic analysis on the EU-China investment relation, including quantitative and qualitative analysis of FDI flows, barriers to investment and the situation regarding investment protection. This impact assessment relies on this study and on previous ones commissioned by DG TRADE.[6]

2.2. Consultation with stakeholders

Numerous consultations with stakeholders and experts took place in 2011 and 2012 to ensure that all interested parties could contribute to the policy decision making process.

2.2.1. Civil Society Dialogue

On 7 February 2011, a special session informing and consulting social partners on the impact assessment on a potential EU-China investment agreement was organised in the context of the regular **Liaison Forum with Social Partners.**

A **first Civil Society Dialogue** on the future EU-China investment relationship was organised on 20 June 2011.A **second Civil Society Dialogue** was held on 7 March 2012, to update stakeholders on the state of play of EU-China investment relations and solicit further feedback.[7]

2.2.2. Public Consultation

A **public consultation on the EU-China future investment** relationship was conducted from 5 May 2011 until 5 July 2011[8]. An online questionnaire, directed at all stakeholders was posted on DG TRADE's website, and advertised on the "Your voice in Europe" website as well as on DG ENTR' European Small Business Portal. 57 exploitable answers were received. Submissions came from private companies, trade associations, a trade union, governmental authorities and NGOs. The full summary of the public consultation is attached in an Annex to this report.

The consultation showed that 41% of business respondents considered China to be among the Top 5 global destinations for European investment in their sector. And 60% of respondents foresaw China to be a Top 5 destination within 10 years. Respondents reported of a multitude of barriers holding up European investment in China like licensing requirements, foreign ownership limitations, Chinese subsidies or joint venture requirements. The consultation further asked stakeholders whether there was need for the EU to facilitate European investment in China for instance through an investment agreement. 81% of respondent

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Health and Consumers, DG Home Affairs, DG Information Society and Media, DG Internal Market and DG Justice, DG Maritime Affairs and Fisheries, DG Mobility and Transport, DG Research and Innovation, DG Taxation and Customs Union, Eurostat, the Legal Service, the Secretariat-General and the European External Action Service.

[6] i.a. EUCTP (2009).

[7] Reports on Civil Society Dialogue: http://trade.ec.europa.eu/civilsoc/meetdetails.cfm?meet=11381

[8] All documents on the public consultation: http://trade.ec.europa.eu/consultations/?consul_id=153

indicated their support for an EU initiative, while 15% of respondents were indifferent. These two groups of respondents are made up by various types of stakeholders in terms of organisation, sector and size. 4% of respondents (equals two responses) replied that there was no need for EU action without further elaborating on this opinion.

In summary, the consultations showed that China is becoming an ever more important destination for European investment despite persisting and significant investment barriers. A broad majority of EU investors expressed their support and interest in the EU negotiating an agreement with China so as to enhance the conditions for European investors in China.

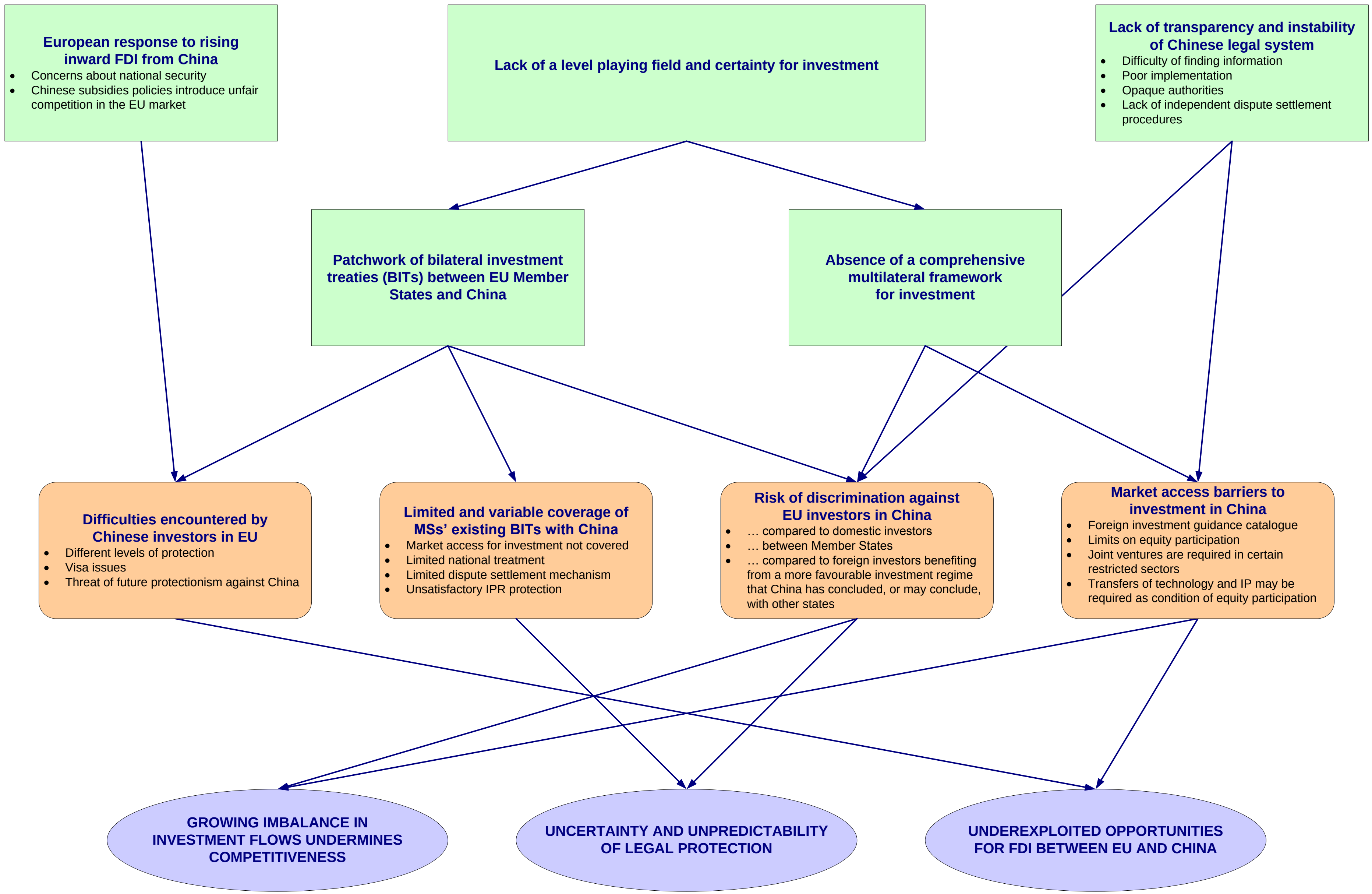
Besides the public consultation, the consultants retained for a study to back up this impact assessment, Copenhagen Economics conducted a business survey. They contacted approximately 1000 companies for its study on EU-China investment relations and received 203 answers. The survey primarily sought to identify-specify barriers to European investments in China. In May 2011, Copenhagen Economics and DG Trade conducted a fact finding mission to China during which they informally interviewed around 20 European companies based in Beijing as well as the EU SMEs' centre and representatives of SMEs in China.

2.2.3. The opinion of the Impact Assessment Board

Following the meeting on 4 July 2012, the Impact Assessment Board, this draft incorporates changes following the recommendations of the IAB in its opinion. This includes a strengthening of the problem analysis under the baseline scenario. Furthermore in the analysis of the different policy options, the qualitative assessment of Option 2 and 3 in relation to investment protection matters has been deepened. A larger section on FDI trends in both directions between the EU and China has been added that also looks at sectoral distribution and types of investment.

The presentation of the various options has been extended also to clarify the fact that Option 2 and 3 are not alternatives as such but that Option 3 integrates Option 2 while adding some additional elements.

The presentation of the results of the economic modelling has been modified to clarify the underlying model and tools used. Finally stakeholder contributions have been more extensively reflected throughout the report and a full summary of the public consultation has been attached as an annex.


European response to rising inward FDI from China
Concerns about national security
Chinese subsidies policies introduce unfair competition in the EU market
Lack of a level playing field and certainty for investment
Lack of transparency and instability of Chinese legal system
Difficulty of finding information
Poor implementation
Opaque authorities
Lack of independent dispute settlement procedures
Patchwork of bilateral investment treaties (BITs) between EU Member States and China
Absence of a comprehensive multilateral framework for investment
Difficulties encountered by Chinese investors in EU
Different levels of protection
Visa issues
Threat of future protectionism against China
Limited and variable coverage of MSs' existing BITs with China
Market access for investment not covered
Limited national treatment
Limited dispute settlement mechanism
Unsatisfactory IPR protection
Risk of discrimination against EU investors in China
… compared to domestic investors
… between Member States
… compared to foreign investors benefiting from a more favourable investment regime that China has concluded, or may conclude, with other states
Market access barriers to investment in China
Foreign investment guidance catalogue
Limits on equity participation
Joint ventures are required in certain restricted sectors
Transfers of technology and IP may be required as condition of equity participation
GROWING IMBALANCE IN INVESTMENT FLOWS UNDERMINES COMPETITIVENESS
UNCERTAINTY AND UNPREDICTABILITY OF LEGAL PROTECTION
UNDEREXPLOITED OPPORTUNITIES FOR FDI BETWEEN EU AND CHINA

3. Problem Definition

3.1. Context: The EU-China investment climate

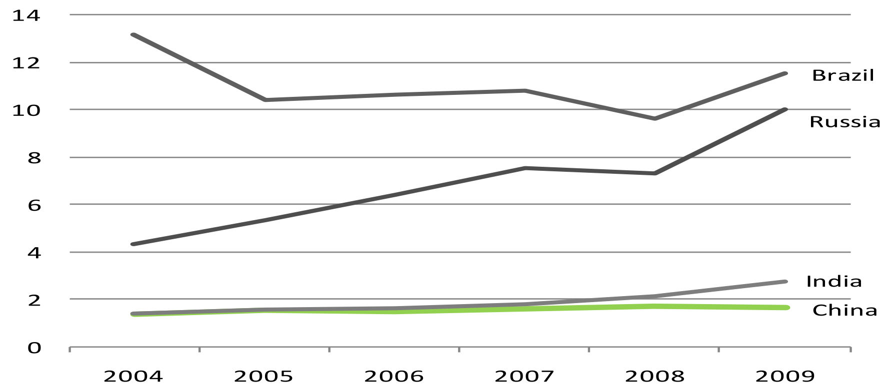
China is the world's second largest economy and the biggest exporter, but also an increasingly important political power. EU-China trade has increased dramatically in recent years. China is now the EU's second trading partner behind the United States and the EU's biggest source of imports by far. International estimates predict China may be on track to become the world's biggest economy within the next 5-10 years. China's rise as a major global economy was boosted by its accession to the World Trade Organisation (WTO) in 2001, which integrated China into the multilateral trading system. WTO accession brought substantial reform and opening up of China's market in many respects but has not resulted in a sufficiently open investment environment.

> Obtaining complete and reliable FDI statistics is notoriously difficult. EU and Chinese data differ widely because of different methodologies used. This impact assessment relies on Eurostat data but at times also presents some MOFCOM data that exemplifies the divergence. Eurostat FDI data is not yet available for 2011

China is regarded as one of the most strategic destinations for FDI by European companies – both at present and for the future. This was confirmed by DG TRADE's public consultation, as well as through other business surveys conducted.[9] In its 2011 annual business confidence survey, the EU Chamber of Commerce in China reports that 59% of respondents declared that they intended to invest in China, up from 39% in 2009.

Yet while FDI between the EU and China has become a more visible factor of the bilateral relationship, there remains an important discrepancy between, on the one hand, the EU-China overall trade relationship and investment on the other. Compared with those of other key trading partners such as the United States and particularly other emerging economies such as Brazil and India, EU-China FDI flows and stocks are clearly lagging behind.

Figure 3.1: EU FDI stock in China compared to EU FDI stocks in other BRICs



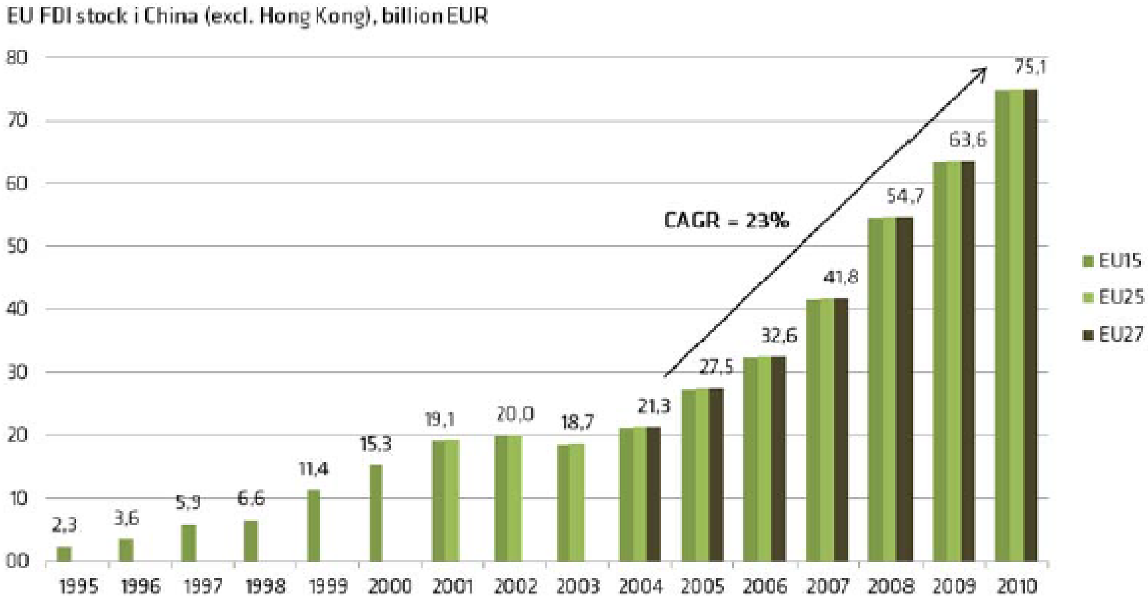
Note: Calculated as the EU's FDI stock in partner country relative to the partner country's nominal GDP
Source: Eurostat, EU direct investment positions, breakdown by country and economic activity

European investments in China started growing at considerable pace in the early 1990s. Prior to 1993, EU investment in China was practically inexistent. By 2001, the EU investment stock had reached €20 billion. By 2010, the EU investment stock had attained more than €75 billion. The EU investment stock in China grew between 2004 and 2010 by more than 23% per year. This trend was not unique to European investment, but reflected the general change

[9] See public consultation; also reflected in: European Chamber of Commerce in China (EUCCC) (2011) *Business Confidence Surevy 2011.*

in Chinese economic policy since the 1990s.[10] Despite the considerable growth of European investment stocks in China over the last 20 years, European investment in China accounts for only 1.8% of Europe's outward investment stocks. Taking into consideration that China has emerged as the EU's second biggest trading partner (13.3% of all extra-EU trade), there is an evident mismatch between EU-China trade and EU-China investment relations.

Figure 3.2.



Note: EU27 data aggregated by Eurostat. EU15 is also shown as it has a longer time series than EU25 and EU27
CAGR = Compound average growth rate in percent over the period indicated.

Source: Eurostat, EU direct investment positions (Financial account direct investment stock abroad)

In 2011, 21% of European investments took the form of mergers and acquisitions of EU firms taking over or fusing with Chinese firms. 34% of European investment was greenfield investment. 52% of investments were reinvestments of earnings of established European investors in China.[11]

Figure 3.3.

Inflows from EU27 to China

Inflows from to China	2005	2006	2007	2008	2009	2010	2011	2012 (*)
Total Amount (in USD bn)	12.8	16.2	13.3	16.0	13.7	8.6	14.1	0.9
- Greenfield Investments	7.1	13.7	10.6	13.1	10.6	5.3	12.7	0.5
- M&A	5.7	2.5	2.7	2.9	3.1	3.3	1.5	0.4
Total Number of Operations	467	548	548	624	414	507	529	84
- Greenfield Investments	404	461	479	531	382	463	474	76
- M&A	63	87	69	93	32	44	55	8

(*) Data up to March for 2012

Source: EU China Economic Observatory (A project by TAC for the European Commission / DG Trade http://www.chinaobs.eu/index.php?tab=home#

[10] Copenhagen Economics (2012), p21-22.
[11] TAC financial research (2012). ChinaObs fdiMonitor. Accessed via http://www.chinaobs.eu/?tab=home.

While in 2011, the EU had emerged as the single biggest investor in China, it needs to be stressed that overall EU FDI into China has decreased (also due to the crisis) and is being hampered by limitations on FDI in China. Yet, it accounted for approximately 5% of FDI inflows into China. European investors placed $14.1 billion into China, followed by the USA ($8.4 billion), Hong Kong ($8.4 billion), Taiwan ($5.4 billion), Indonesia ($4.6 billion) and Japan ($4.5 billion). Within the EU, Germany figures as by far the most important investor in China. In 2011, German firms accounted for $9.2 billion or 65% of all EU FDI flows into China, followed by British ($1.2 billion) and French ($1.1 billion) investors.[12] The EU-15 accounts for 99% of European investment into China.[13]

It is interesting to note that European investment in China is concentrated in a handful of economic sectors and activities and is equally distributed between manufacturing and services sectors.[14] Chemicals (23%), metal (19%) as well as automotive and transport equipment (20%) were the sectors, which attracted most European investment in 2009. Real estate (39%) and finance (39%) are the main sectors of European investment flows into Chinese services sectors. Investments in other activities like mining, agriculture, construction or electricity are of only marginal size – in all of these sectors significant restrictions to FDI exist either through the Investment Catalogue which prohibits and restricts parts of these sectors or administrative burdens and requirements – something that is particularly the case in the construction sector.[15]

China in turn has become an increasingly active outward investor, now ranking among the top 10 global investors. The largest increase occurred in the past ten years after China officially initiated a "go global" strategy to promote outward FDI. At present, China accounts only for circa 5% of global FDI outflows and receives 8.5% of inflows, while holding 3% of the world's inward stocks and 1.5% of the total outward FDI stock. Starting of course from a very low base a decade ago, the figures have risen sharply in recent years. According to a recent study by the Rhodium Group[16] Chinese outward FDI may amount to between €800 billion and €1.6 trillion between 2010 and 2020. Around one-quarter of this sum is projected to go to the EU.

Chinese FDI flows into the EU grew by over 100% in 2010 compared to 2009 according to the Chinese Ministry of Commerce (Mofcom) data. Indeed, in 2011, Europe was the main destination for Chinese FDI. However, the total FDI figure remains marginal compared to EU inward FDI stock of which it still represents just below 1%. Chinese FDI stock in the EU amounts to something between €6.7bn (Eurostat) € 9bn (Mofcom) which is around 0.2% of total inward FDI stock in the EU. China ranks only as number 18 of all investor countries in the EU.

[12] Ibid..
[13] Copenhagen Economics (2012), p.21.
[14] Data on European investment by sector is limited and numbers often substantially diverge due to methodological obstacles. Hence, the a cautious regard is required.
[15] Copenhagen Economics (2012), p21-22.
[16] Rhodium Group (June 2012) China Invests in Europe Patterns, Impacts and Policy Implications, Thilo Hanemann and Daniel H. Rosen

Figure 3.4.

Outflows from China to EU27

Outflows from China to	2005	2006	2007	2008	2009	2010	2011	2012 (*)
Total Amount (in USD bn)	4.3	2.0	6.3	16.1	1.3	2.5	7.9	1.3
- Greenfield Investments	0.1	1.4	0.3	0.9	0.2	0.3	0.6	0.2
- M&A	4.2	0.6	6.0	15.1	1.1	2.3	7.3	1.1
Total Number of Operations	58	30	92	90	130	152	168	34
- Greenfield Investments	47	26	74	78	115	137	135	17
- M&A	11	4	18	12	15	15	33	17

(*) Data up to March for 2012

Source: EU China Economic Observatory (A project by TAC for the European Commission / DG Trade *http://www.chinaobs.eu/index.php?tab=home#*

In addition, investment flows channeled via Hong Kong and tax havens are significant and may obscure total flows originating in China. With regard to EU outflows, DG TRADE estimates that EU FDI channelled into China via Hong Kong amounts to approximately € 1.2bn in 2010, or 17% of all EU FDI into China. For Chinese outward FDI, recent MOFCOM figures show that Hong Kong accounted for 55% of all Chinese FDI outward flows in 2010. Looking at stocks, Eurostat's 2010 figures show that Hong Kong accounts for 1.4% of total FDI-Stocks in the EU (against China's 0.2%). In terms of amount invested, according to the data compiled by the EU-China Observatory, EU27 as a whole is the first destination for Chinese investors over the 2005-2011 period, followed by Hong Kong, Canada, Brazil, Australia and the USA.

Figure 3.5.

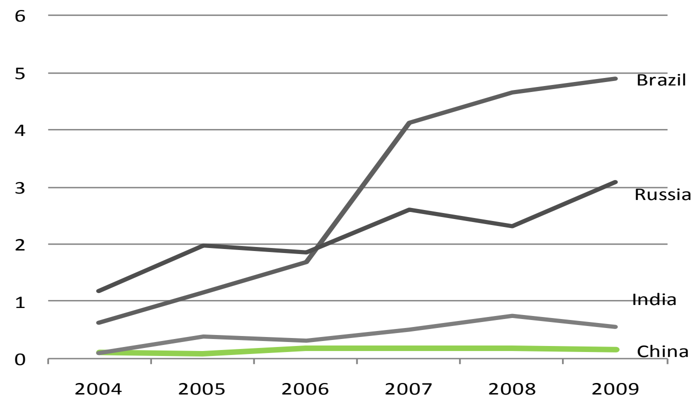
Chinese FDI outflows over the 2005-2011 period

Rank	FDI destination	% of total
1	EU27	13%
2	Hong Kong	7%
3	Canada	7%
4	Brazil	7%
5	Australia	7%
6	USA	6%
7	Russia	3%
8	Indonesia	3%
9	Singapore	3%
10	India	3%
	Total in bn USD	308.4

Source: TAC/COFM

Source: EU China Economic Observatory (A project by TAC for the European Commission / DG Trade *http://www.chinaobs.eu/index.php?tab=home#*

Figure 3.6: Chinese FDI stock in the EU compared to FDI in the EU by other BRICs



Note: Ratio calculated as FDI in EU27 from partner country as a share of the partner country's nominal GDP
Source: Eurostat, EU direct investment positions, breakdown by country and economic activity

The trend towards a continuous increase of Chinese FDI to the EU is expected to continue. Furthermore, the structure of China's investment outflows is changing more and more. While the very first Chinese FDI was concentrated on infrastructure in order to support the distribution of Chinese exports and then shifted to resources targeting mainly developing countries, particularly Africa and South America, China has now moved up the value chain and invests in Europe in order to sell products, expand production chains and acquire technology, brands and human talent. Chinese FDI in the EU is spread across a wide range of sectors in both manufacturing and services.
The top four industries by value have all seen at least one large-scale acquisition – utilities (CIC-Gas de France), chemicals (Wanhua-Borsodchem), automotive (Geely-Volvo) and coal, oil and gas (Sinochem-Emerald). In terms of number of deals, communication equipment and services, industrial machinery and renewable energy attracted the largest Chinese investment values.[17] However these sectors are not the most capital intensive, hence average deal size is smaller. Automotive components, financial services and software and IT services have also received a significant number of investments across Europe.

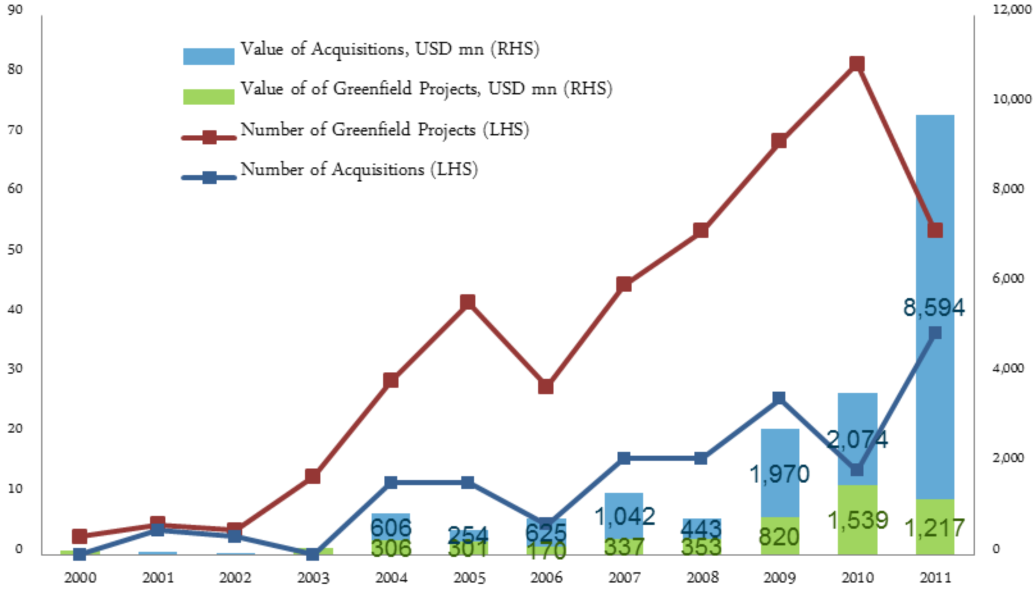
It is also interesting to analyse whether most FDI is made via mergers and acquisitions or constitutes greenfield investment. To overcome the shortcomings of official Eurostat and Mofcom data, the findings of both Rhodium Group and the EU-China Economic observatory which compile their own datasets where used. The data stemming from this approach are not directly comparable to the traditional Balance-of-Payments approach to collecting FDI data, as they neglect reverse flows and miss intra-company loans and other follow-up flows. However this method overcomes many of the weaknesses of the traditional approach – most importantly the use of offshore financial centers for acquisitions – and allows a detailed, real-time assessment of Chinese investment flows and ownership in Europe.

For the period 2000-2011, 573 transactions worth $21 billion were recorded (Figure 17). Before 2004, there were fewer than 10 deals per year, with an average annual investment value below $100 million. From this modest beginning a significant upward trend has developed. The period 2004-2008 saw the annual average number of acquisitions and greenfield investments grow to 50, with investment value averaging around $800 million per year. For 2009-2010, the number of deals increased to 100, and annual inflows hit $3 billion.

[17] Rhodium Group (2012)

For 2011, we recorded 54 greenfield investments and 37 acquisitions with a total investment volume of almost $10 billion – a threefold increase over the previous two years.

Figure 3.7.: Chinese Direct Investment in the EU-27, 2000-2011 (*Number of deals and USD million)*



Source: Rhodium Group (2012).

While these numbers seem at first glance impressive, they need to be put in perspective. A few large-scale transactions can easily distort the overall picture – even in this approach Chinese FDI into the EU still only accounts for 4% of total EU inflows.

3.2. <u>Lack of level playing field for prospective and existing European investors in China</u>

The public consultation highlighted that, despite the growing attraction and strategic importance of China as an FDI destination, the lack of a predictable and secure environment both for prospective and existing investors negatively affects EU outwards FDI flows to China. The result is not only an untapped potential, but also a growing imbalance, given the relative absence of barriers in the EU towards increasing Chinese inward investment.

In the *OECD FDI Restrictiveness Index 2010*[18], China appears as the most restrictive of the countries examined, with an FDI restrictiveness index of 0.457 (0 being totally open, 1 being totally closed). Moreover, this restrictiveness index has worsened since 2006, where China ranked 3rd, behind India and Iceland, with an index of 0.405.

The current bilateral and multilateral framework for investment between the EU and China does not offer the possibility to comprehensively address this situation which is unsatisfactory for the future competitiveness of European investors.

At the same time it is equally important to consider the interests of China. While current FDI flows and stocks from China into the EU may still be relatively low, they are increasing

[18] OECD (2010a).

rapidly. China has expressed a vested interest in negotiating an EU-wide investment protection agreement and ensuring that the EU maintains its current level of openness to Chinese investors.

3.2.1. Market access limitations for EU investors in China

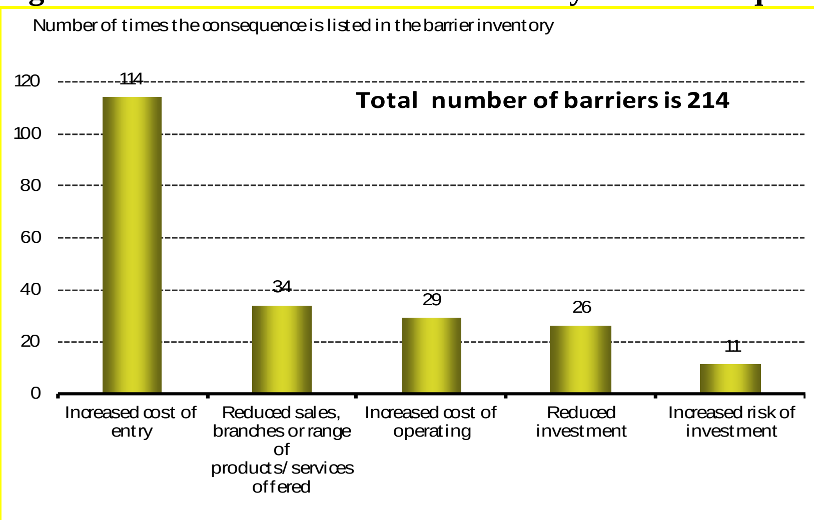
Market access barriers persist at various levels, not least due to China's selective investment screening policy, with several important sectors entirely closed to foreign investors. Others are only partially opened, and investors may face numerous restrictions that include being prevented from setting up wholly owned foreign enterprises and having to fulfil local content requirements or overly burdensome procedures. Concerns about requirements to establish joint ventures are aggravated by anxieties about the protection of investments due to forced transfer of key technologies and the lack of sufficient protection of intellectual property in China.

The public consultation confirmed that 77% of business respondents had experienced difficulties when investing, or trying to invest in China. 25% of this group of respondents (9 respondents) even stated that those difficulties had deterred them from going through with investment plans. When asked to list and rate the kind of barriers considered most problematic for companies investing, or trying to invest in China the following were named as the top five:

- licensing requirements/procedures
- foreign ownership limitations
- regulatory approval procedures
- prohibition to invest/limited scope of business
- joint venture requirements.

In the survey by Copenhagen Economics (2012) the barriers listed as most frequently encountered included the same as above as well as capital requirements, standards and testing requirements, a general lack of transparency and lack of consultation with foreign investors (e.g. for establishing new standards) and qualification requirements for personnel. A compilation of measures per sector constituting barriers to investment was undertaken for this analysis. It found more than 250 investment barriers, if taken as single measures. The survey undertaken by Copenhagen Economics found that there was a range of consequences to these barriers, including an increase in the cost of entering the Chinese market (see figure 3.3 below).

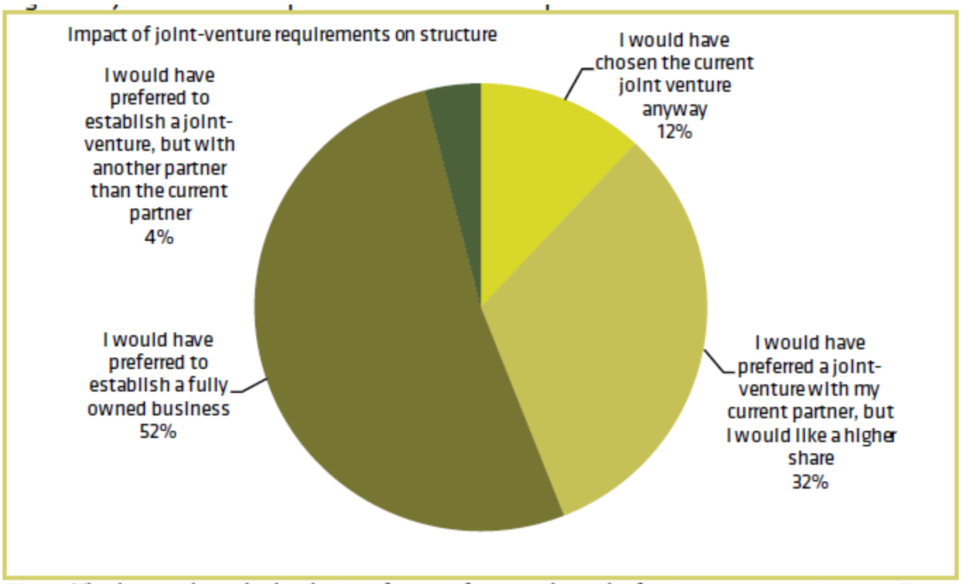
Figure 3.9: Chinese investment barriers by main consequence



Source: Copenhagen Economics inventory of Chinese investment barriers

Responses from survey of Chinese investment barriers also show the impact of specific restrictions such as joint venture requirements. In the majority of cases, the respondent company would have chosen a different ownership structure and in more than half of the cases the company would have preferred to establish a fully owned business.

Figure 4: Impact of JV requirements



Note: The diagram shows the distribution of answers for respondents who face joint venture requirements. Responses are left blank when the company belongs to an industry where joint venture requirements are not prevalent. The figure is based on 25 responses

Source: Copenhagen Economics survey of Chinese investment barriers facing EU investors

In the public consultation, over half of the respondents (51%) considered that there were specific issues concerning European SMEs in relation to investment between the EU and China. While essentially the barriers encountered by SMEs are the same as for large companies, SMEs face even more problems in tackling these due the burden on resources. Certain barriers were perceived to be more problematic, such as access to financing in China, high capital requirements or procedures to establish a company.

Requirements amounting to investment barriers can be included in horizontal rules or sector-specific legislation or can result from poor implementation and enforcement. With regard to the overall framework for investment in China, the key guidelines are contained in the Foreign Investment Guidance Catalogue[19], promulgated by the National Development and Reform Commission and the Ministry of Commerce. The latest version of the Catalogue entered into force on 30 January 2012. It classifies sectors of economic activity into three categories: prohibited, restricted and encouraged for foreign investment. Sectors listed under "prohibited" are entirely closed to foreign investors, which constitutes an absolute market access barrier. Examples include domestic postal and courier services, many subsectors in mining and most aspects of news, media and television. Furthermore sectors listed as "restricted" or even those listed as "encouraged" can be subject to numerous limitations and conditions for foreign investment including foreign ownership caps, restrictions of the scope of business, obligations for joint ventures or other requirements. These are not spelled out in the list of the Catalogue. Finally, there are specific industry plans for certain sectors, such as automotives or the postal sector that may lay down further targets and rules.

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[19] Mofcom (2012) Catalogue of Industries Guiding Foreign Investment

China may also adopt new regulations that supersede the Catalogue. Contradictions between the Catalogue and other measures have added to the perception that there is no secure basis for business planning. The practical implications of listing a sector in a given category are uncertain, and this undermines confidence in the stability and predictability of the investment climate. However, it should be pointed out that China recognises that commitments on investment in international trade agreements would take primacy over the Catalogue. Thus binding commitments in an investment agreement could create the certainty which is lacking at present.

3.2.2. Discriminatory treatment of established investors in China

Respondents to the public consultation & business surveys[20] identified the lack of legal certainty and transparency as a main obstacle encountered by investors in China.

Among the top barriers named above, some – such as licensing requirements, regulatory approval procedures but also protection of intellectual property and key technologies – concern the treatment experienced after an investment has been done and also relate to the implementation and enforcement of rules/legislation. Therefore these are not barriers to access the Chinese market but result in discriminatory treatment of foreign investors.

Equally, investors feel that recourse to judicial remedies in China is not sufficient. In the public consultation, 80% of the respondents who expressed an opinion on the Chinese legal system said that they did not have confidence in it to protect their rights as investors. They explained that the Chinese legal system lacked transparency and consistency, both in the decisions and in the judicial process itself.

In addition, state owned enterprises (SOEs) play a specific role and local (even private) companies and government officials maintain close relations. Respondents to the public consultation stressed that the legal decision process was subject to political pressure, both from the local SOEs and from the administrative agencies at central, provincial and municipal level, which have a strong discretionary power to decide on foreign investments.

Investors have also underlined the negative impact and unlevel playing field that the Chinese subsidy policies are creating – in particular in some key areas such as the automotive sector or research and development. Apart from the advantages they enjoy through subsidies, SOEs and private Chinese enterprises are considered to enjoy an unfair competitive advantage when it comes to public procurement or bidding procedures, either because they can leverage their financial advantages gained via subsidies and access to loans, or because foreign invested companies are simply excluded.

Discriminatory treatment of foreign investors at various levels, as well as lack of sufficient protection of their assets, increase risk and uncertainty and can threaten the viability of existing investment.

[20] The *2011 Business Confidence Study* by the European Union Chamber of Commerce in China (2011) shows growing concerns over a perceived unlevel playing field from EU investors. 20% of respondents stated that Chinese policies regarding foreign invested enterprises led them either to suspend new investments, reduce/slow existing investment plans or even reduce/suspend existing investments in China.

3.3. Lack of comprehensive framework to remedy shortcomings of the EU-China investment relationship

The two main challenges of the current investment relationship from an EU perspective – the lack of market access and discriminatory treatment of foreign investors – cannot be easily addressed given the lack of a comprehensive legal framework. None of the ongoing multilateral and bilateral negotiations, dialogues and fora, currently provides a comprehensive or promising framework under which the most pertinent issues on investment can be tackled holistically.

3.3.1. A patchwork of bilateral investment agreements is leading to an unlevel playing field between investors from different Member States and China

Currently, 25 Bilateral Investment Treaties (BITs)[21] concluded between individual EU Member States and China since 1982 co-exist. They cover all EU Member States but Ireland[22]

This patchwork of agreements results in an uneven level of protection for investors. This is all the more so as there is a clear discrepancy between the standards of protection granted by the existing BITs of EU Member States with China.

The different BITs broadly fall into two groups:

Pre-1998 BITs: Agreements signed before 1998 lack important provisions guaranteeing substantive and procedural protection of foreign investment, or contain significant reservations. These **11 BITs** suffer from lower standards of protection than the "new" generation of BITs and thus these 11 Member States[23] would stand to benefit most from a uniform high standard of protection.

Post-1998 BITs: Agreements signed after 1998 benefited from China's "going out" policy and include stronger investment protection provisions. These **14 BITs**[24] generally contain all standard provisions found in recent BIT practice, including general principles of fair and equitable treatment, full protection and security, non-discrimination, as well as investor-to-state dispute settlement which can be invoked with regard to all provisions under the agreement. At the same time though these agreements are not uniform either.Additionally, even these new generation BITs are missing in certain cases important elements:

- Provisions granting national treatment, the principle of giving third country investors the same treatment as one's own investors and their investments, are currently weak in a majority of BITs. Only the BIT between China and Cyprus contains an unconditional national treatment commitment.
- While all contain a "Most Favoured Nation"[25] (MFN) clause, unlimited MFN treatment is only guaranteed in eight[26] agreements.
- Investor-to-state dispute settlement arbitration is subordinated to the exhaustion of local review procedures, even if it is limited to a period of three months (NL, FI, LT, SP, CZ).

[21] See annex 1 for a list of BIT in force between Member States and China; See annexe 2 for glossary and definition of BITs.
[22] Belgium and Luxemburg have one common BIT.
[23] AT, BU, DK, EE, GR, HU, IT, LI, PL, SV, UK
[24] BE & LU, CY, CZ, DE, ES, FI, FR MT, NL, LV, PT, RO, SK, , SE
[25] See Annexe 2 for explanation.
[26] LV, EL, DK, FR, DE, UK, SE, SK

Crucially, there are also types of clauses that are **entirely absent in both old and new** generation BITs that are much in the focus of stakeholders. In particular in discussions with civil society and the European Parliament the European Commission has been called upon to ensure that a future EU investment policy promotes the integration of these clauses that are currently absent in all Member State agreements with China and are only present in some other BITs into EU investment agreements[27]:

- No current Member State BITs with China, includes clause preventing attraction of FDI through a non-lowering of standards (e.g. environmental, labour laws) by the parties to the agreement. This is something not contained currently in any MS BIT with China which does have no provisions to enforce the respect for such standards.
- No current BIT includes a reference to the issue of corporate social responsibility or the OECD *Guidelines on Multinational Enterprises*
- No current BIT includes comprehensive provisions regarding questions over state-owned enterprises, subsidies and performance requirements including forced technology transfer.

It should also be considered that BITs are not concluded for an indeterminate period of time. Of the existing 25 BITs, 10 could cease to offer protection before 2023 if terminated by one of the parties. The Slovakia-China BIT could possibly be terminated and expire by 2017.[28] At the same time, under the current post-Lisbon investment regime, Member States cannot negotiate or renegotiate BIT any longer, unless empowered by the European Commission.

Finally, all existing BITs with China are limited to provisions dealing with protection of investment once the investment has been made – none deals with the question of market access for prospective investors (pre-establishment). Other countries, such as the United States and Canada pursue investment agreements that combine both, protection of investment and market access. An EU-China investment agreement would offer the opportunity to have a full comprehensive and uniform agreement, including market access and protection provisions on investment.

3.3.2. An incomplete multilateral framework

Investment is not covered under the WTO agreements in a comprehensive manner. Investment, one of the so-called "Singapore issues" was dropped off the WTO agenda at the 2003 Cancun Ministerial Conference. Since then, there have been no multilateral negotiations in the WTO or any other body on investment. Negotiations on a *Multilateral Agreement on Investment* (MAI) within the framework of the OECD stopped in the late 1990's and there are currently no proposals to re-initiate talks that could eventually lead to such an agreement.

However, there are investment disciplines which vary from sector to sector and country to country:

- The WTO General Agreement on Trade in Services ("GATS Agreement") covers establishment – that is the supply of services by a foreign company setting up an operation in a host country through foreign direct investment. While China's sectoral coverage is relatively extensive under its commitments taken upon its accession in 2001, there are also broad limitations. As regards progress within the WTO, the

[27] Examples of such clauses can be found e.g. in the BITs between China and New Zealand and Singapore. In the EU BITs Belgium and Luxembourg have included some references to labour standards. Also the new US Model BIT text includes references to non-lowering of standards.

[28] See list in annexe 1 on entry into force, expiry and sunset clauses of all 25 EU MS-China BITs

current Doha Development Agenda (DDA) round is stalled and is not expected to be concluded in the close future. In addition, China consistently refers to its status of "newly acceded member" as a justification not to take further commitments in the DDA.

- The Agreement on Trade-Related Investment Measures ("TRIMs Agreement") prohibits certain trade-related investment measures that affect trade in goods, such as local content requirements. However, the reach of the commitments taken by China under TRIMS is limited.
- There are no WTO binding rules on foreign direct investment in sectors other than services and no immediate prospects for negotiations.

Rules on investment also exist in the context of the OECD, but China is not a member and it is not likely to adhere to the relevant OECD codes even though this would be possible also for a non-member.

3.3.3. EU-China PCA negotiations and prospects for an FTA

An improvement of the EU-China bilateral investment relationship cannot reasonably be expected, neither from the ongoing PCA negotiations nor from an FTA.

Negotiations on an EU-China Partnership and Cooperation Agreement (PCA) have been ongoing since 2007. The PCA is not a preferential trade agreement in the meaning of the WTO (i.e. no further liberalisation of tariffs and services).

The EU proposed a chapter on establishment and services, integrating regulatory provisions and liberalisation commitments for non-services sectors. However China indicated that they did not have a mandate covering the liberalisation of investments in non-services. Furthermore, China has made it clear that its main interests lie in the area of investment protection, which in turn is not covered in the European Commission's negotiating directives, which pre-date the entry into force of the Lisbon Treaty and hence of the new competence on investment. It seems unrealistic to expect any progress on the trade related parts of the PCA in the near future that could improve the EU-China investment relationship.

An EU-China Free Trade Agreement is not politically feasible in the near future. China has made it clear that it is not interested and EU stakeholders do not support such an agreement.

3.4. China's and the EU's bilateral agreements and negotiations with third countries and implications for investment

The EU is currently negotiating FTAs with India, Canada and Singapore where the negotiating guidelines have been modified to also include investment protection. Hence, these three partner countries stand to be the first potentially to benefit from a uniform EU-wide standard of protection as well as further investment liberalisation. The EU and Japan are moving towards a negotiation of an FTA.

China has concluded free trade agreements with Taiwan, as well as with Hong-Kong and Macau, ASEAN, Pakistan, Chile, New Zealand, Singapore, Peru and Costa Rica. It is currently negotiating FTAs with the Gulf Cooperation Council, Australia, Iceland, Norway and the South African Customs Union. In addition there are plans for FTA negotiations with South Korea and Japan as well as with Switzerland. In terms of investment market access, the agreements with Hong Kong, Macau and Taiwan are most ambitious but mostly in the area of services. Australia is also pushing for further market access on investment as are Korea and Japan in the context of a possible FTA. While to date China has been reluctant to negotiate market access in non-services this is not excluded *per se*. Indeed, China can grant preferential market access commitments in a derogation of the investment Catalogue. Any commitments in an international trade agreement would have primacy over the investment catalogue rules.[29]

As regards bilateral investment agreements, China and the United States have been negotiating a Bilateral Investment Treaty since 2008. Canada and China concluded negotiations on a BIT in February 2012. Details of the final text have not yet been disclosed. China in May 2012 also concluded BIT negotiations with Korea and Japan. The agreement only deals with post-establishment investment protection.

It is possible that China could grant preferential access as well as more comprehensive protection standards and transparency to other trading partners, which would put EU investors at a competitive disadvantage.

3.5. Concerns linked to Chinese investments in EU

Whereas the initial Chinese outward FDI was focused on natural resources and energy (and thus on Africa and Latin America) it is now shifting into manufacturing and overseas production, sectors with technology and specific know how (such as solar energy, construction, components), consumer brands and services. When it comes to investment in Europe, Chinese companies are choosing to invest increasingly via mergers and acquisitions rather than greenfield investment. This creates the perception of a strategic "takeover" by Chinese companies. In this context, there seems to be a growing public perception of an alleged danger that Chinese FDI into the EU entails unfair acquisition of key technologies and knowhow by state owned enterprises or companies under indirect control of the Chinese government, which could adversely affect strategic interests in the European Union. However, 65% of respondents to the public consultation had no concerns about Chinese state owned companies investing into the EU. Yet, more than one third of respondents expressed concerns notably over the access to capital and the unfair advantages Chinese subsidies might afford to these state owned companies when participating in European public procurement procedures. Some respondents also raised concerns over Chinese investments in key technologies or in critical infrastructure in the EU.

As explained earlier, the actual figures on FDI flows and stock show clearly that Chinese FDI into the EU is still marginal. Analysing the sectors into which Chinese companies invest there is also little to suggest that they would target sensitive sectors for strategic or geo-political purposes. However, this impact assessment also looks at how the conduct and government treatment of state-owned enterprises could be addressed through a potential bilateral agreement.

3.6. The EU investment environment for Chinese investors

China has also a number of genuine interests with regard to the EU.
As already explained above, China considers that the current situation of having different BITs with Member States as difficult and sub-optimal. It is therefore strongly interested in negotiating a uniform EU level agreement on protection of investment.

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[29] See to this effect the Foreign Investment Catalogue, which contains the following paragraph: "1.If there are other provisions in the Mainland and Hong Kong Closer Economic Partnership Arrangement and its supplements, the Mainland and Macau Closer Economic Partnership Arrangement and its supplements, the Cross-strait Economic Cooperation Framework Agreement and its supplements, and the free trade zone agreements concluded and signed by and between China and other relevant countries, such provisions shall prevail. 2. If there are other provisions in the special regulations or industry policies of the State Council, such provisions shall prevail."

While the EU has less formal restrictions on FDI than China and does not pursue a systematic FDI screening policy, China has raised concerns on a number of barriers which its investors are confronted with when investing in the EU. Many EU Member States maintain some prohibited or restricted sectors or ex-ante authorisation procedures for foreign investors seeking to invest in certain sectors. China has also complained in the past that licensing and authorisation or application of certain standards at times is more burdensome for foreign investors than for EU nationals and companies and has also highlighted an alleged lack of legal transparency and high administrative burden in the EU. As such China also has an interest in ensuring market access for its investors.
China has also complained that the lack of uniform rules, for example in the area of services, continues to hamper access to the EU market for investors.

China and its investors are becoming increasingly concerned about alleged growing protectionist sentiments in Europe and a backlash against Chinese investors also reflected in the media. There have been increasing calls in the EU for stronger controls of FDI inflows on the basis of national security or even industrial policy concerns amounting to a more restrictive EU policy on FDI. While this issue as such is a separate one to this agreement, China has a key interest in negotiating with the EU and thus securing commitments in an agreement on investment safeguarding the EU existing openness for the future.

Furthermore, China has linked the question of market access of investment to that of the granting of visas and work permits for Chinese nationals. Indeed, China feels that EU Member States have adopted a stricter visa policy notably towards intra-corporate transferees from Chinese-funded companies in the EU, which in their eyes amounts to a disincentive to investment in the EU from Chinese businesses. This discussion is likely to resurface in any future talks on investment. To date existing BITs include mostly best endeavour language on this issue. EU FTAs include commitments on temporary movement of service suppliers or intra-corporate transferees, which are however unrelated to visa and work permit questions.

Finally, although this is an unrelated question, China still continues to demand that the EU grant it market economy status for anti-dumping purposes. In the past, it has linked this to discussions about openness for investors.

4. OBJECTIVES

4.1. General objectives

The EU's general objective derives from the Treaty on the Functioning of the European Union, which in Articles 3(1) (e), establishes the EU's exclusive competence for the common commercial policy and through Article 206 provides that "the Unions shall contribute to progressive abolition of restrictions on (…) foreign direct investment". Article 207 (1) sets out the need for uniform principles including for FDI and liberalisation measures. It also sets out that the common commercial policy shall be conducted in the context of the principles and objectives of the Union's external action as set out in Article 21 of the Treaty on European Union[30].

[30] Article 21 para 1, The Union's action on the international scene shall be guided by the principles which have inspired its own creation, development and enlargement etc and 2 (e) TEU: "The Union shall define and pursue common policies and actions, and shall work for a high degree of cooperation in all fields of international relations, in order to encourage the integration of all countries into the world economy, including through the progressive abolition of restrictions on international trade".

4.2. Specific objectives

With respect to future EU-China investment relations, the EU's general policy objectives translate into:

- Improving legal certainty regarding treatment of EU investors in China,
- Improving the protection of EU investments in China,
- Reducing barriers to investing in China,
- Increasing bilateral FDI flows.

China's specific objective is mainly to improve the legal certainty of Chinese investors in the EU and to preserve its current access to the EU.

4.3. EU Operational objectives

In light of the overall objective regarding the EU-China investment relationship and considering the problems mapped out in sections 3.1 through 3.7, the operational objectives are as follows:

1. Provide EU investors better market access and effective non-discrimination for investments (both before and after establishment),
2. Increase the transparency and predictability of controls or screening of European investment into China that are based on unclear or excessively wide definitions of national interest beyond narrow national security concerns,
3. Seek the highest possible level of uniform standards of legal protection and certainty for European investors in China, building on the best practice of EU Member States and in doing so remedying the current patchwork of existing BITs which provide for different levels of protection,
4. Ensure that investment protection standards include strong protection of intellectual property rights,
5. Seek to increase Europe's attractiveness as a destination for Chinese foreign direct investment by offering a uniform European standard of protection to Chinese investors,
6. Increase transparency by e.g. ensuring consultations of stakeholders in advance of introduction of regulations having an impact on investment, publication of such rules and transparency as regards the administration, implementation and application of regulations having an impact on investment,
7. Ensure the creation of enquiry points and one-stop shops designed to provide specific information and to respond promptly to questions and enquiries by investors regarding the operation of the Agreement,
8. Seek to improve the competitiveness of EU companies investing in China and ensure a more level playing field to remedy the (discriminatory) advantages enjoyed by Chinese state owned enterprises or the effects of loans and subsidies. Equally consider how to ensure a level playing field in the EU in the context of investments by state owned enterprises or subsidised companies from China in the EU,
9. Ensure the right of the parties to take measures necessary to achieve legitimate public policy objectives (including e.g. environmental, social, labour and human rights objectives) on the basis of the level of protection that they deem appropriate, provided that such measures do not constitute a means of unjustifiable discrimination or a disguised restriction,

10. Seek to ensure that domestic laws and policies provide for high levels of environmental and labour standards and that the parties shall not encourage foreign direct investment by weakening or reducing domestic environmental or labour legislation and standards, or by relaxing core labour standards or laws aimed at protecting and promoting cultural diversity including by failing to effectively enforce such legislation and standards,
11. Seek to include a reference to obligations of investors' regarding corporate social responsibility
12. Ensure the enforcement of any agreed rules through adequate dispute settlement including access to out of Court arbitration.

4.4. China's operational objectives

Looking at the overall problems defined for the EU-China investment relationship, it is evident that China's key interests lie more in the area of seeking a uniform European treatment and protection for its investors than in more access to the European market since the EU is already characterised by a high degree of openness for FDI. At the same time, concerns in China are also growing over the increasing backlash against Chinese investors in Europe and increasing calls for control of FDI inflows on the basis of national security or even industrial policy concerns. As such China also has as an objective to safeguard the existing openness of the EU. Some of the objectives are the same essentially as the EU's though they of course may differ in the substance of the negotiated outcome:

1. Seek the highest possible level of legal protection and certainty for Chinese investors in the EU building on China's existing body of BITs and remedying the current patchwork of Bilateral Investment Agreements between EU Member States and China,
2. Aim for the promotion of the highest Chinese standards of protection and seek to increase China's attractiveness as a destination for EU foreign direct investment,
3. Safeguard existing openness and legal certainty in the EU for Chinese investors addressing both existing and future market access and national treatment across economic sectors,
4. Ensure that Chinese investors, intra-corporate transferees and business visitors linked to setting up an establishment or maintaining it (as well as possibly their family members) enjoy facilitated access to visas and granting of work permits in the EU,
5. Seek to provide for the creation of enquiry points and one-stop shops designed to provide specific information for investors and to respond promptly to questions and enquiries by the parties regarding the operation of the Agreement,

4.5. Consistency of objectives with other relevant policy initiatives

The EU's objectives are consistent with the overall objectives established by the Treaty and also are in line with the Commission Communication "*A strategy for smart, sustainable and inclusive growth – Europe 2020*" which sets out the overall objectives for the decade to come and particularly emphasises the need to build strategic relationships with emerging economies. Trade and investment are a crucial component of the triple growth objective of the Europe 2020 Strategy. The objectives are furthermore consistent with the Communication adopted on 7 July 2010 entitled "*Towards a comprehensive European international investment policy*".

5. POLICY OPTIONS

This chapter outlines the four different policy options that have been considered by the Commission in order to achieve the objectives set out in Chapter 4.

Option 1	Baseline scenario: No agreement – continue with the status quo
Option 2	EU Commission recommendation for negotiating directives for standalone investment protection agreement
Option 3	EU Commission recommendation for negotiating directives for an agreement combining investment protection with market access
Option 4	EU Commission recommendation for modifying the existing negotiating directives for the PCA to include investment protection
Option 5	Seek a comprehensive FTA with China rather than pursuing a sectoral agreement

To set these policy options into context, it should also be considered that both the EU and China will conclude a number of agreements in the coming years that will pursue both preferential market access for investment as well as comprehensive investment protection.

As with the objectives, regarding all options it should be kept in mind that the Commission's possible legislative initiative subject to the analysis of this impact assessment would be a recommendation to the Council to authorise negotiations and adopt negotiating guidelines. Such guidelines in their final form express objectives but do not prejudge the outcome of a negotiation and thus grant some inbuilt flexibility as to the precise negotiated outcome.

5.1. Option 1: No policy change: Baseline scenario

A first policy option would be to continue to operate under the current framework of bilateral policy dialogues and existing multilateral commitments, negotiations and the renegotiation of the Partnership and Cooperation Agreement (PCA). Since the Commission's negotiating directives do not include investment protection, it would be impossible, without changes to the directives, to pursue protection. At the same time the Chinese mandate does not cover investment liberalisation for non-services sectors. Under this scenario the existing 25 BITs between China and the EU would remain in place as the framework for protecting investors. It should be pointed out that BITs can be terminated and may require renegotiation which in turn would only be possible if individual Member States are empowered by the European Commission (see Annex 1 on existing BITs between EU and China).

5.2. Option 2: A standalone investment protection agreement

The second policy option would be for the Commission to propose negotiating guidelines for a standalone investment agreement between the EU and China to replace the 25 existing BITs with one single agreement for the EU. This agreement would cover protection and treatment of investments once undertaken (post-establishment), but not market access.

To this end the Commission would make a recommendation to the Council for negotiating guidelines pursuing the highest level of investment protection possible, building essentially on Member States' best practice. This would contain all standard provisions found in recent BIT practice and improve these where possible to ensure more legal certainty and consistency with EU policy objectives. Furthermore under this option the EU would seek to include clauses regarding the non-lowering of labour and environmental standards, corporate social responsibility and provisions dealing with the question of state-owned enterprises and performance requirements.

5.3. Option 3: A separate agreement combining investment protection with market access

A third policy option for the Commission would be to propose negotiating guidelines for a standalone investment agreement which would integrate Option 2 (a standalone protection agreement that covers investment protection for made investments) with further elements to cover also pre-establishment (i.e. market access). As such this Option builds on Option 2 – in that sense it is complementary to Option 2 rather than an alternative option.

This approach would apply the established EU FTA practice of including provisions on establishment for all sectors for national treatment and market access with horizontal and sectoral liberalisation commitments aiming at the facilitation of investment flows and improvement of treatment, in a manner consistent with the GATS with regard to services.

Under this Option, there are several scenarios possible in terms of ambition on market access related provisions. The economic modelling undertaken looks at ambitious and modest liberalisation scenarios. However, these should not be seen as separate sub-Options but rather as potential negotiation outcomes.

5.4. Option 4: Integrating protection into the current negotiating guidelines for the PCA and thus covering both market access and protection in the PCA

As a fourth policy option, it is mentioned that it could be conceivable for the Commission to make a proposal to amend the PCA negotiating guidelines to include investment protection.

However, given the clear gap in mandates and ambitions of the EU and China regarding both the political and the trade and investment part of the PCA negotiations, it is highly unrealistic that progress or a conclusion of these negotiations could happen any time soon. It seems unlikely that the overall stalemate in the PCA negotiations could be overcome since the gap does not seem bridgeable at this stage on other key trade chapters including services, sustainable development, IPR and procurement. Furthermore it would be more difficult to engage China in a discussion over the mandate and scope on investment in the context of a negotiation where so many other substantive differences persist.

Therefore this Option cannot be considered a realistic, feasible policy option to achieve the objectives.

5.5. Option 5: A comprehensive FTA with China including investment protection and ambitious market access for investment

This Option is mentioned for completeness but it will be not explored further since there is no interest on the side of China to negotiate an FTA with the EU in the nearest future.

This scenario cannot therefore be considered as a realistic policy option.

6. ANALYSIS OF IMPACTS

This chapter analyses the impacts of the different policy options from various perspectives looking both at general impacts as well as sectoral impacts were applicable.

6.1. Economic impacts of the different policy options

The options considered include to investment protection and to a varying degree market access elements. The study of Copenhagen Economics (2012) analysed the impact on FDI flows and on economic activity in both EU and China of replacing the 25 existing BITs by an EU level agreement reinforcing and harmonising investment protection and of reducing market access barriers and discriminatory treatment for foreign investors on FDI, under several scenarios of ambition. This in turn allows also drawing conclusions as to the foregone

opportunities under the baseline scenario which would entail no changes to the current situation.
The effects of higher standards of investment protection and the possibility to improve/add provisions that are not covered in the current situation are analysed on a qualitative basis since empiric literature is inconclusive as to the correlation between investment protection agreements/standards and FDI flows and as such these provisions have various effects including increasing legal certainty but these effects cannot be quantified.

The analysis as regards changes in FDI flows relied on econometric techniques (gravity model) to estimate the impact of improved investment access conditions for European companies in China on FDI stocks in a partial equilibrium setting and on a computable general equilibrium model (CGE) in order to quantify the potential economic gains in a general equilibrium context.

The modelling of FDI flows and the impact of reduction of barriers to investment with a CGE model involved an innovative extension of the CGE framework that is usually employed to assess the impact of changes in trade policy.
The starting point was the standard GTAP trade policy model, which is widely used in trade analysis in the Commission and elsewhere and its underlying database. This model was extended to take into account the changes to investment barriers. This is fully spelled out in the study and in the methodological annex to this report. On this basis, a set of 8 policy scenarios was simulated in order to provide a sufficiently robust policy sensitivity analysis.
This modelling tool developed by Copenhagen Economics is currently the only and best option available to analyse changes in FDI rules in a general equilibrium setting. The methodological approach that was developed involved merging conventional production, demand and trade data with information on FDI from the Eurostat dataset (FATS) on operations of European affiliates in China that include both Multinational Enterprises' (MNE) turnover and employment.

The underlying model is then based on the complementarity between trade and FDI.[31] In other words, it rests on the idea that the lowering of investment restrictions (in this case in China) leads to an increase of EU affiliates' sales (in China), which is in turn associated with an increase of exports of intermediates from Europe (more for manufacturing than services). In addition, more bilateral trade of final goods could also be generated by the business networks that MNEs build following the setting up and expansion of affiliates' activities in China.

The investment barriers have been measured with an index of perceived restrictions which was calculated on the basis of a detailed inventory of barriers and a survey among EU investors. Given the way the survey was conducted and given also the features of the CGE model, the quantitative analysis captures only the increase in operations of European firms already present in China (the intensive margin) and their impact on the overall economy via the intensification of trade flows not the entry of new firms and goods in the market (the extensive margin).

The CGE analysis was complemented further with a novel (yet fully grounded on robust academic references) econometric estimation of the impact of reducing FDI restrictions (based on the survy) on FDI stocks. Different robustness checks of the econometric estimates

[31] This complementarity is justified on the basis of the information included in the GTAP8 database and on a review of specific econometric evidence (see Copenhagen Economics 2012)

were also carried out, notably by comparing with other estimates based on the use of alternative measurements of FDI restrictiveness, notably the OECD FDI restrictiveness index and using non-linear estimators.

For this reason, the results reported should be considered as very conservative, presenting the lower bound of the potential impacts of an investment agreement with China (see Annex 3 on methodology of the Copenhagen Economics study).

6.1.1. **Option 1: the baseline scenario**

The baseline scenario assumes no changes in the current situation regarding investment policy vis-à-vis China and takes as a basis the status quo regarding openness and legal certainty of the EU's and China's respective investment environments. No progress should be expected on further market access and improvement of investment conditions under either the WTO DDA or the PCA negotiations for investment in the near or medium term. Under Option 1, the current BITs would remain in force regarding investment protection.

The quantitative modelling tools do not permit to model the dynamic evolution of a "non-shocks" scenario under Option 1. Therefore, although there could be consequences in terms of foregone opportunities, these cannot be quantified.

At the same time, of course the expected gains modelled under option 3 give an indication of the kind of foregone opportunities to be expected. The simulations presented for the Option improving market access were conducted in such a way that the gains estimated occur irrespective of changes in the global macroeconomic environment.

On the basis of the current FDI environment and trends, it could be expected that Chinese FDI into the EU would continue to increase and EU FDI into China would decrease. Furthermore, important sectors in China remain closed to EU investors – a situation that could not be remedied under current circumstances. The problems relating to barriers in sectors where FDI is possible would also persist. The asymmetry between EU openness and Chinese restrictiveness could not be addressed. In addition the shortcomings explained with regard to investment protection in the problem definition section under 3.3.1. demonstrate in which respects the current situation is sub-optimal.

6.1.2. **Policy Option 2: Impact of an investment protection agreement.**

By replacing the existing 25 BITs with one single EU-China BIT, the level of protection for EU investors originating from a Member State having a BIT with China that provides only weaker standards of protection should improve, to the level of protection equivalent to that provided by the "stronger" BITs.

Qualitative and econometric studies analysing[32] the correlation between pure investment protection BITs and FDI flows between two signatory parties are inconclusive and suggest that investors take the existence of BITs into account but only as one of several factors conditioning an investment decision.

The existing BITs concluded by Member States with China only apply to investments post-establishment and as such may improve the situation and legal certainty once an investor has

[32] See Copenhagen Economics (2012) Chapter 4; Guerin (2010), UNCTAD (2009)

invested but do not open up new sectors to FDI. An analysis of these BITs does not give any conclusive indication of how they may have impacted FDI flows in the past.

However, there are important qualitative elements to consider in the impact analysis of Policy Option 2. As section 3.3.1 outlines, there are important discrepancies between the level of protection granted in the different 25 existing BITs between EU Member States and China. These are legal elements (including the provisions on national treatment, MFN clause, investor to state dispute settlement) that could be made more coherent and stringent in a new EU level agreement. Additionally, a new standalone agreement would enable the EU to seek to include provisions entirely missing from the existing BITs including an obligation for the non-lowering of standards by parties to the agreement in the attraction of FDI as well as a reference to corporate social responsibility of investors.

An overwhelming majority of respondents to the Copenhagen Economics survey stressed the importance of an EU level agreement for better, more coherent protection of investments and legal certainty. However, more than 40% of companies that responded to the survey answered that the presence of a BIT was not at all important for their initial decision to invest in China.

Overall it appears that pure investment protection BITs are considered by investors as an important insurance policy and as recourse in cases of adverse decisions by the host State. This in itself is an extremely important aspect of a future agreement. However, the economic value of the increase of legal certainty cannot be quantified through economic modelling and it is therefore not possible to measure an economic impact as expressed in an increase of FDI under Option 2.

6.1.3. Policy Option 3: Impact of an agreement including investment protection and liberalisation

It should be stressed that Option 2 and Option 3 are in fact complimentary not alternative options. Option 3 includes all aspects of Option 2 (investment protection) while adding to it elements of market access/investment liberalisation. Since there can be a measurable effect of more investment liberalisation and FDI flows, investment liberalisation under Option 3 can be additionally analysed using quantitative modelling tools.

To analyse the impact of investment liberalisation through improved market access, two main scenarios with different levels of outcomes (modest and ambitious) were simulated, both scenarios being very conservative[33]:

- The modest liberalisation scenario simulates a 3% reduction in the cost of the estimated barriers to investment;
- The ambitious liberalisation scenario simulates a 10% reduction in the cost of the estimated barriers.

This rather conservative approach to the likely outcome of negotiations is motivated by the current legal frameworks of the EU and China (as given based on the index of restrictiveness)

[33] On the basis of the restrictiveness index, the study estimated the impact of restrictions in China on the cost of operation of European MNEs econometrically, including both production activities within China, and the ability of European firms to sell goods and services from home through those same affiliates. The reductions in restrictions (3% and 10%) have then been applied to the cost equivalents of the investment restrictions.

and by the fact that the further reduction of barriers is only one of the elements to be negotiated, (the increase of legal certainty for investors being the other main pillar considered).

In particular, the large asymmetry in the current levels of openness/restrictiveness between the EU and China suggests that a conservative scenario would be the best basis for the analysis. The fact that the EU is one of the most open economic areas in terms of FDI while, China is among the most restrictive, points to the idea that a negotiation cannot realistically aim at closing this gap entirely. The consequence of grounding the analysis on two rather conservative scenarios is that the impacts identified with the modelling are necessarily rather small.

For each of these scenarios two sub cases have been considered:

- A unilateral liberalisation outcome (where only China reduces its restrictiveness)[34]
- A reciprocal liberalisation outcome (where both EU and China reduce restrictiveness).

The question of whether the elimination of regulatory barriers can yield improved access for third countries (henceforth referred to as "third country spillovers") and the potential effects is also analysed. This is particularly important in investment agreements. Firstly, MFN clauses (see glossary) can extend to the investors and the investments of the Parties to an agreement (in this case the EU and China respectively) the treatment which the Parties grant to any third country investors and even more crucially it can also mean that more favourable treatment granted by the EU and China in a future bilateral investment agreement has to be extended to investors from other countries with whom agreements with an MFN clause have been concluded by either party. Secondly, barriers to investment are mostly of a regulatory nature, i.e. occur by means of laws or regulations of general application which in many cases do not distinguish foreign investors of different origins.

Two possibilities were examined, for each of the scenarios considered:

- A high spillover situation (where 60 percent of any cost savings also accrue to third countries)
- A low spillover situation (where 10 percent of any costs savings also accrue to third countries).

Given the degree of asymmetry between the EU and China in terms of openness to FDI, these scenarios of investment liberalisation try to simulate different attainable outcomes of such a negotiation.

The results of these simulations should, however, be interpreted as lower bounds of the impact of the possible investment agreement. Firstly, the policy scenarios considered are conservative. Secondly, the underlying assessment of levels of restrictiveness was based on a survey which included only foreign companies that had already invested in China. Thus, it cannot capture the cost of important barriers to investment that are preventing EU firms from investing in China. Therefore the model cannot show the economic effects of the potential entry of EU firms in such sectors, were the negotiations to be successful in lifting such barriers.

[34] Because of the significant difference in the degree of restrictiveness between EU and China (see chapter 3) and the interest Chinese authorities have expressed for a uniform European protection agreement (see chapter 4), a unilateral removal of market access barriers can be envisaged. While the EU would commit existing openness (and thus provide China with guarantees), China would have to actually commit a reduction in restrictiveness.

6.1.3.1. Expected impact on FDI stocks and overall welfare under option 3

Policy Option 3 is expected to trigger a moderate increase in EU-China investment flows and stocks. The investment liberalisation and the increased EU-China investment stocks should also lead to increase in trade activity, which will in turn have a positive impact on the economy at large. Policy Option 3 should thus have positive, but modest, effects on European and Chinese welfare.

Impact on FDI stocks

The econometric gravity estimates, based on EUROSTAT FDI stock data (balance of payments), show that with a moderate reduction in barriers to investment, EU FDI stock in China would slightly increase (+0.6%) while Chinese FDI stocks in the EU would remain stable compared to the baseline. In case of a more ambitious reduction, the EU FDI stock in China is projected to increase by 1.9 percent. While the increase in EU FDI stock in China is the same independently of whether the removal of barriers is reciprocal or not, the impact on Chinese FDI stock in the EU would modestly increase in the case of a reciprocal scenario. These estimates amount to € 348 million of additional EU FDI into China for the moderate scenario and up to € 1.1 billion for the ambitious scenario.[35] The increase of Chinese FD stock in Europe would increase by € 17 million or € 51 million € respectively.[36]

Table 6.1: Investment liberalisation scenarios

Impact on FDI from investment liberalisation	Moderate scenario		Ambitious scenario	
	% increase in the EU FDI stock in China	% increase in the Chinese FDI stock in the EU	% increase in the EU FDI stock in China	% increase in the Chinese FDI stock in the EU
Non-reciprocal scenario	0,6%	0,0%	1,9%	0,0%
Reciprocal scenario	0,6%	0,3%	1,9%	0,9%

Source: Copenhagen Economics (2012) gravity of bilateral investment stocks

Note: These results are obtained using an OLS estimator. Copenhagen Economics (2012) reports additional estimates using a Poisson estimator which delivers higher effects. However we only report the more conservative, lower bound estimates.

Expected economic impact on EU enterprises in China overall

In 2007, turnover of European MNEs in China amounted to €48.7 billion, representing 7.4 percent of the global (extra-EU) total. These same firms employed 582.600 people in China, representing 17.1 percent of the total extra-EU employment of EU MNEs.

Table 6.2: Baseline turnover of EU MNEs in China, million Euros – 2007 data

Sector	Million Euros	Global share (%)
Manufacturing	48,721	7.4
Other goods	199	0.1
Services	52,600	3.3
Total	**101,520**	**4.2**

Source: Eurostat, February 2012 extraction, FATS data

[35] Calculations based on a figure of €58 billion for the stock of FDI of the 15 Member States with the largest investments in China in 2009, see Copenhagen Economics (2012).

[36] Calculations based on a figure of €5.7 billion for China's FDI stock in the EU in 2009, see Copenhagen Economics (2012).

The reduction of the cost of the operations of EU companies in China, which is an outcome of the reduction of the investment barriers[37], leads to an increase of the activities of their Chinese affiliates. The increase in the turnover of the affiliates of EU MNEs in China could range from € 195 million to € 1.7 billion euros (depending on the scenario considered). The impact on employment is also positive (although very modest): 2000 to 17.500 additional jobs, could be expected depending on the scenario.

Overall the conclusion is that the improved legal framework for EU MNEs in China would allow them to expand their operations in China, increasing their turnover and labour force.

Table 6.3; Impact on EU MNEs in China -- experiments A-H (fixed labour supply)

	Reciprocal				**Non-reciprocal**			
	Modest		**Ambitious**		**Modest**		**Ambitious**	
	Low spillovers	**High spillovers**	**Low spillovers**	**High spillovers**	**Low spillovers**	**High spillovers**	**low spillovers**	**high spillovers**
	A	B	C	D	E	F	G	H
Turnover in China, million Euros								
Manufacturing	1,175	686	348	205	981	434	290	131
Other Goods	0	0	0	0	0	0	0	0
Services	508	226	151	69	374	224	114	64
Total	1,683	911	499	274	1,356	657	404	195
Employees in China, thousands								
Manufacturing	14.0	8.2	4.2	2.5	11.7	5.2	3.5	1.6
Other Goods	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Services	3.5	1.5	1.0	0.5	2.6	1.5	0.8	0.4
Total	17.5	9.7	5.2	2.9	14.3	6.7	4.3	2.0
Percent change in FDI stocks								
Manufacturing	2.41	1.27	0.71	0.38	1.96	0.81	0.58	0.24
Other Goods	0.02	-0.32	0.01	-0.10	-0.13	-0.15	-0.04	-0.06
Services	0.96	0.29	0.29	0.09	0.65	0.35	0.20	0.10
Total	1.85	0.89	0.55	0.27	1.46	0.64	0.43	0.19

Source: Estimates from CGE model results

Expected impact on trade

As highlighted in Copenhagen Economics (2012), research suggests that trade and FDI are complements, i.e. that an increase in FDI activity can trigger an increase in trade flows. The available literature suggests that FDI stimulates exports of other goods or services either from the parent company (intra-firm trade) or from other companies (inter-firm trade). This effect seems to be more important than the substitution of some exports by the additional FDI. Overall the study expects the EU-China investment agreement to promote trade between the EU and China, insofar as it succeeds in stimulating FDI between the two countries. This

[37] The study estimates the savings of reducing China's restrictiveness to the EU level to be on average 11.9% of the costs of operation for EU companies in China. While this is of course not a realistic outcome of a potential investment agreement negotiation, it gives a good indication of the scope of the overall additional costs companies face due to the current high level of restrictiveness.

effect is fully captured in the CGE simulations and the macroeconomic effects described above are also driven by this.

Table 6.3 above shows the positive impact that an investment agreement would have on trade. Total EU exports to the world would increase in all the scenarios envisaged, with the highest impact created by an ambitious reciprocal agreement with high spillovers. In that scenario EU exports would expand by 0.12%, while China's exports would increase by 0.11%. China's exports to the world could marginally decrease in the case of a non-reciprocal and low-spillovers negotiation outcome.

In terms of bilateral trade, the tables below (6.4 and 6.5) examine the changes in EU exports to China and EU total exports. They show that: (i) the impact of the agreement on EU exports to China will always be positive in all of the scenarios envisaged (validating the claim that FDI and trade activity between EU and China are complementary) and mostly driven by manufacturing sectors, and (ii) that in the case of low spillovers scenarios the growth in bilateral exports explains most of the increase in EU exports.

Table 6.4.:Impact on EU exports to China -- experiments A-H

	Reciprocal				**Non-reciprocal**			
	Modest		**Ambitious**		**Modest**		**Ambitious**	
	Low spillovers	High spillovers	Low spillovers	High spillovers	Low spillovers	High spillovers	Low spillovers	High spillovers
	A	B	C	D	E	F	G	H
Exports f.o.b., million Euros								
Manufacturing								
(base: € 75.5b)	1,833	1,071	543	321	1,534	675	454	204
Other Goods								
(base: €1.6b)	1	-3	0	-1	-1	-1	0	-1
Services								
(base: €19.7b)	191	85	57	26	141	84	43	24
Total	**2,024**	**1,153**	**600**	**345**	**1,673**	**758**	**496**	**228**

Source: Estimates from CGE model results

Table 6.5: Impact on EU exports to World - experiments A-H

	Reciprocal				**Non-reciprocal**			
	Ambitious		**Modest**		**Ambitious**		**Modest**	
	Low spillovers	High spillovers	Low spillovers	High spillovers	Low spillovers	High spillovers	low spillovers	high spillovers
	A	B	C	D	E	F	G	H
Exports f.o.b., million Euros								
Manufacturing								
(base: €1,057.2b)	1,963	4,530	573	1,344	1,167	1,929	349	539
Other Goods								
(base: €30.0b)	2	-7	0	-3	-29	-41	-8	-13
Services								
(base: €401.2b)	214	384	64	109	56	27	18	6
Total	**2,178**	**4,907**	**638**	**1,450**	**1,193**	**1,916**	**358**	**532**

Source: Estimates from CGE model results

Additionally, comparing the tables 6.4 and 6.5 above it is clear that that the additional "kick" in EU exports in the high spillover scenarios follows not from greater EU MNE activity in China itself (and the associated additional export growth to China) but from the increased third country demand. With a broader (non-EU specific) liberalisation of investment in China, there is increased third country demand for intermediate imports from the EU as well, as non-EU MNEs move into China and/or expand their activities there.

As an example, the Copenhagen Economics (2012) looks at the case of an EU car manufacturer that invests in a production plant in China with the purpose of selling more cars on the Chinese market. While some of the inputs for car manufacturing would be sourced locally in China (and may indeed be required to do so given the problematic local content requirements), other parts could be sourced outside China, including from Europe. As car sales in China by the EU car manufacturer increase, so do the imports of intermediate inputs from Europe. In this example, increased FDI would lead to increased EU exports. This is supported by the fact that a large share of goods imported into China is destined for intermediate use, i.e. as input for further processing in China.

Overall macroeconomic impact

The broader macroeconomic impact in China and in the EU of the envisaged scenarios are summarised in table 6.6 below.

All scenarios have a very small but positive impact on real income in the EU, and positive and slightly bigger impact on real income in China. The ambitious liberalisation scenario would yield more substantial benefits than the modest scenario, not only for the EU, but also for China.

Table 6.6 Macroeconomic effects - experiments A-H

	Reciprocal				Non-reciprocal			
	Ambitious		**Modest**		**Ambitious**		**Modest**	
	Low spillovers	High spillovers	Low spillovers	High spillovers	Low spillovers	High spillovers	Low spillovers	High spillovers
	A	B	C	D	E	F	G	H
Change in real income, % (based on welfare)								
European Union	0.02	0.05	0.01	0.02	0.01	0.02	0.00	0.01
China	0.04	0.07	0.02	0.02	0.02	0.09	0.00	0.03
Change in real income, million Euro								
European Union	2,361.0	7,010.9	698.7	2,095.7	1,311.0	2,720.0	393.4	773.4
China	1,443.2	1,405.4	431.0	424.5	265.3	2,029.1	81.2	542.5
Consumer prices, %								
European Union	-0.01	-0.05	0.00	-0.01	0.01	0.02	0.00	0.01
China	-0.02	-0.15	-0.01	-0.04	-0.06	-0.10	-0.02	-0.03
Total exports to the world, %								
European Union	0.05	0.12	0.02	0.03	0.03	0.05	0.01	0.01
China	0.18	0.11	0.05	0.03	-0.02	0.12	-0.01	0.04
Total imports from the world, %								
European Union	0.05	0.11	0.02	0.03	0.03	0.05	0.01	0.01
China	0.22	0.19	0.07	0.06	0.00	0.19	0.00	0.06

Source: Copenhagen Economics (2012).
Note: In the table, results have been rounded at the second digit therefore a 0.01 percent variation actually represents values ranging from 0.0099% to 0.0056%. For the impact on income the corresponding results expressed in euro give the accurate values.

The results also show that the greater the spillovers linked to reductions of restrictions on investment, the larger the economic gains for the EU and China, in terms of national income. This pattern holds regardless of whether concessions are reciprocal or not, due to the impact of China's removal of barriers on the rest of the world (and thereby on EU exports to the rest of the world). It is also important to note that in all scenarios (modest and ambitious, high and low spillovers) the EU always has more to gain (in terms of national income) in a reciprocal setting. More specifically, the EU would be better off if it extended market access concessions to third countries, as they are larger suppliers and there is less scope for diversion of trade and investment. This is particularly true in the case of reciprocal concessions. For China, there are some cases where low spillovers and high spillovers are comparable (in particular in the reciprocal scenarios). In the non-reciprocal cases, China also is clearly better off due to broad-based improvements of access conditions that spill over to third countries.

Impact of increased Chinese investment in the EU

Increased Chinese investment in the EU will potentially contribute to economic growth and employment by financing profitable investment. This growth promoting effect of the investment agreement is all the more important given the current economic crisis and scarcity of capital that has followed the banking and financial turmoil in the EU.

Concerns have been raised that foreign investors (including Chinese) may aim at acquiring and transferring back to their home countries firm-specific knowledge and technology. This might have a negative impact on the EU economy, in the longer term. However, there is no evidence to support this hypothesis. In general, previous econometric studies[38] have found strong empirical support for the economic benefits of inward FDI across all types of regions and industries by strengthening their productivity and competitiveness. Among the main elements that can be drawn from the literature, we highlight the following:

- While it is not always clear if acquisition by foreign investors increases the target firm's productivity (because investors often acquire firms that are already more productive), there is evidence that host countries/regions enjoy positive productivity spillovers from inward FDI. Such positive spillovers tend to be transmitted though backward (suppliers) and forward (clients) linkages. The average increase in productivity in the country/region translates into economic growth and an increase in competitiveness.
- The extent to which the host country benefits from positive productivity spillovers will depend on the technological, organisational and managerial competences of the foreign company.
- Compared to FDI from more advanced countries such as the US and Japan, the productivity spillovers from Chinese FDI should be expected to be smaller. But potentially the presence of Chinese producers in Europe could also promote access to the Chinese market for at least the firms acquired, increasing the scale of production and therefore the productivity.

These specific channels for additional benefits from FDI cannot be captured by the CGE model used in the previous section.

[38] Copenhagen Economics (2006).

Impact in the EU of increased European outward investment to China

Outward FDI may have potentially a two-fold effect on the EU economic activity. Outward FDI enhances productivity and competitiveness of the home country (EU firms) firms as they acquire new market access in the host country and are able to import intermediate goods from foreign affiliates at a lower cost. However, critics have also argued that outward investment substitutes domestic with foreign production, reducing investment and employment in the home economy, thereby negatively affecting economic growth and jobs.

In a recent survey[39] of the existing empirical literature on how EU outward FDI generally impacts on productivity, employment, wages and skill structures in EU firms it was found that:

- EU outward FDI has triggered significant productivity and hence competitiveness gains of EU firms. This effect of outward FDI is less pronounced for investments in less developed countries.
- EU outward FDI has had no measurable impact on aggregate employment so far. Over time, there is no indication that employment in the parent company is put under pressure by low wages in the host country of the foreign affiliate. Short term employment losses because of the relocation of production are compensated by the positive effect on employment of increased productivity and scale effects.
- Outward FDI has real redistributive impacts where skilled workers gain relative to unskilled workers.

The CGE simulations confirm that on average there is no negative overall impact on EU employment from increased activity of European MNEs in China. In the case of the ambitious scenario with high spillovers, the impact is positive although small (0.03%) and this is linked to greater economic expansion and greater demand for EU exports but also to supply chains linking EU firms to other non-EU firms that might gain access to China. However, the general equilibrium model shows some potential re-allocation of jobs across sectors. This will be further discussed in the section below.

6.1.3.2. Expected impact on specific key sectors

The CGE simulations also provide detailed sectoral impacts of the liberalisation of investment (under the same scenarios described above) for the activity of EU MNEs in China and for the sectoral output in the EU.

Given existing data limitations the impact on EU MNEs' activities in China cannot be as detailed as the results for the activities in the EU. For example, the FATS dataset used to quantify the impact of the agreement on the operation of EU MNEs in China does not provide specific details on different services activities but only the overall effect in the service (non-trade) sector.

In addition, given the often very low levels of initial investments in some sectors, the CGE estimations tend to deliver a very low impact for any liberalisation, because – as already mentioned – it does not account for the entry of new firms. For this reason any sectoral results need to be considered as the lower bound of the likely effects.

While as a general rule this report presents all the different scenarios that were simulated, in the case of specific sectoral effects, we are focusing on the reciprocal, ambitious and high

[39] Copenhagen Economics (2010).

spillover scenario since these show the largest overall economic impact - – tables 6.7 and 6.8 provide an overview of the changes at the level of sectoral activity of EU firms both in China and within the EU respectively

This modelling had to be done on the basis of two different model closures (fixed labour closure and flexible labour closure), which broadly reflect the two standard types of adjustment that one can consider to take place in the labour market:

- One assumes that the aggregate employment levels do not change and that all adjustments to the policy changes are done via wages;
- The other assumes that the policy shock will have temporary effects on wages and that this will lead to a long-run change in the aggregate level of employment.

The results for the sectoral effects in terms of output need to reflect these different possible labour market adjustments. Given that this created 16 sets of results, it was decided to focus on the effects of the experiment that is associated with the largest positive and negative aggregate economic impact. All other results are available in the appendix to the Copenhagen economics study (tables A4.2, A4.3, A4.4, and A4.5).
Most of the macro-economic increase in turnover of EU MNEs in China is expected to be in manufacturing, and in particular in machinery and non-trade services. These increases are expected to compensate the small decrease in turnover in chemicals and transport equipment.

Regarding the sectoral output in the EU, there is, as expected, a marginal re-allocation of output across industries. The sectors that will see their output decrease the most are ferrous metals, metals and metal products, machinery and equipment, as well as communication services. In contrast, sectors such as motor vehicles and transport equipment will see the largest expansions of output. Given the overall positive impact on EU income and exports under this same scenario (see above), the increases in output in some industries will overall compensate the decreases in others.

Table 6.7: Impact on EU MNEs' turnover in China (million euros)

Reciprocal, ambitious , high spillovers scenario	Baseline	Change	
Manufacturing	48.721	719	
motor vehicles	3.642	-8	
other transport equipment	4043	-46	
chemicals, rubber, plastics	6.959	-84	
petrochemicals	795	-2	
machinery	12.587	389	
electrical machinery	5.678	270	
other machinery	6.909	120	
other manufactures	20.695	470	
Other Goods	199	-1	
Services	52.600	153	
trade	19.840	-138	
other services	32.760	291	
TOTAL	101.520	871	

Source: Copenhagen Economics (2012). *Note:flexible labor supply closure*

Table 6.8: Change in EU output (percent)		
Reciprocal, ambitious and high spillovers scenario Sectors	**Change**	
agriculture forests fish	0,052	
Mining and energy extraction	0,008	
food beverages tobacco	0,080	
Textiles	0,005	
Wearing apparel	-0,023	
Leather products	-0,060	
Wood products	-0,002	
Paper products, publishing	0,108	
Petroleum, coal products	0,047	
Chemical, rubber, plastic products	0,070	
Mineral products nec	0,161	
Ferrous metals	-0,118	
Metals nec	-0,367	
Metal products	-0,113	
Motor vehicles and parts	0,696	
Transport equipment nec	0,480	
Electronic equipment	0,844	
Machinery and equipment nec	-0,132	
Manufactures nec	0,062	
Utilities	0,146	
Construction	0,087	
Trade	0,079	
Transport nec	0,043	
Sea transport	-0,023	
Air transport	-0,078	
Communication	-0,170	
Financial services nec	0,093	
Insurance	0,091	
Business services nec	0,054	
Recreation and other services	0,067	
PubAdmin/Defence/Health/Educat	0,062	

Source: Copenhagen Economics (2012), Note: Flexible Labor Closure

6.1.3.3. Expected economic impact on third countries

As explained in section 6.1.3., regulatory changes to the investment conditions as well as the use of MFN clauses mean that bilateral market access concessions may in effect benefit third countries as well.

However, overall the economic effects on third countries are small. As indicated earlier, the scenarios with high spillovers would deliver the best economic outcome for the EU and China. This is true also for third countries that will gain from the fact that China reduces investment restrictiveness not only vis-à-vis the EU but also for their firms., In that case the liberalisation of FDI would lead to increased activity in China of EU as well as other foreign MNEs. This explains why in such situation the increase of EU total exports is greater than the increase in EU exports to China. The difference is due to the additional EU exports to meet the increased demand in third countries.

When analysing the impact on third countries' real income, it is also the ambitious reciprocal and high spillover scenario that leads to the most pronounced effects. In that scenario most countries will see their real income expand in respond to the EU-China bilateral investment agreement. The most pronounced gains will accrue to Canada (+0.09%), followed by Korea (+0.05%), Russia and Turkey (+0.04%). In contrast, there is a loss in real income in the ASEAN countries (-0.05%), and Japan (-0.03%). Trade linkages are important drivers of these changes in real income in third countries. Canada's gains are linked to its role as supplier of raw materials to the entire East Asian industrial base, so the more the activity in the region increases the more Canadian GDP and export increase. Japan, in contrast, faces stronger competition from China, and the more ambitious scenarios with greater MFN elements to the liberalization actually magnify this. Hence, exports and GDP fall more in the high spillovers scenarios. Finally for the US, to whom the region is also an important destination for MNEs and related shipment of intermediate goods, there is not the additional aspect of raw material linkages as we have with Canada. As such, while the direction of results for the US and Canada are similar, the relative impact is much greater for Canada, reflecting differences in the patterns of production and trade linkages. Russia is in a similar position to Canada.

Overall, there is evidence of heightened competitive pressure and modest gains and losses within East/South East Asia itself, while for most countries outside the region, the higher impact scenarios bring (small) gains.

On the other side, when only China liberalises (non-reciprocal scenario), the impact on third countries is for the most part negative although small. In fact, although the MFN nature of the agreement matters the most in exacerbating the economic impact on third countries, the reciprocity nature of the agreement is also important. In particular, the two economies that lose the most in terms of income in the reciprocal, ambitious, and high spillover scenario (Japan and ASEAN), benefit from a better outcome if the agreement is non-reciprocal (in the case of ASEAN real income will go up by as much as 0.05% if the agreement is ambitious, not reciprocal with high spillovers). One explanation for this may be that in the case of a reciprocal agreement the increased activity of Chinese MNEs in the EU (and the associated increase in EU-China bilateral trade) will displace some of the EU-Japan and EU-ASEAN trade.

Table 6.9: Macroeconomic Effects for third countries -- experiments A-H (fixed labor supply)

	reciprocal				non-reciprocal			
	ambitious		modest		ambitious		modest	
	low spill-overs	high spill-overs	low spill-overs	high spill-overs	low spill-overs	high pill-overs	low spill-overs	high spill-overs
	A	B	C	D	E	F	G	H
Change in real income, %								
(based on welfare)								
Brazil	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
India	0,00	0,02	0,00	0,01	0,01	0,01	0,00	0,00
Russia	0,00	0,04	0,00	0,01	0,00	0,01	0,00	0,01
Turkey	0,00	0,04	0,00	0,01	0,01	0,03	0,00	0,01
ASEAN	0,00	-0,05	0,00	-0,02	-0,01	0,05	0,00	0,01
Japan	0,00	-0,03	0,00	-0,01	0,00	0,00	0,00	0,00
Korea	-0,02	0,05	-0,01	0,01	-0,02	0,00	0,00	0,00
Canada	0,00	0,09	0,00	0,03	0,01	0,02	0,00	0,01
USA	0,00	0,01	0,00	0,00	0,00	0,00	0,00	0,00
Other High Income	-0,02	0,03	-0,01	0,01	-0,04	-0,16	-0,01	-0,04
Rest of the World	0,00	0,01	0,00	0,00	0,00	0,00	0,00	0,00
Total	**0,00**	**0,01**	**0,00**	**0,00**	**0,00**	**0,00**	**0,00**	**0,00**
Change in real income, (million euros)								
Brazil	0,7	56,3	0,2	16,9	7,7	26,2	2,3	8,4
India	30,6	169,3	9,3	49,9	56,2	94,0	16,7	28,2
Russia	-15,2	386,1	-5,1	118,6	-16,4	122,0	-5,0	45,8
Turkey	22,3	211,1	7,0	63,3	34,8	115,7	10,5	31,8
ASEAN	10,9	-344,8	3,4	-116,0	-80,0	366,3	-23,7	60,3
Japan	-41,1	-838,4	-10,6	-239,4	50,8	-173,1	15,5	-65,8
Korea	-97,5	221,4	-29,4	69,0	-100,1	13,9	-30,1	17,9
Canada	36,0	704,5	10,3	206,1	54,8	181,8	15,9	73,2
USA	84,8	1.150,6	25,2	337,8	243,6	411,7	72,0	152,9
Other High Income	-182,7	224,5	-58,9	61,0	-406,6	-1.748,3	-124,2	-446,2
Rest of the World	4,6	-204,5	0,9	-61,7	-315,6	-524,7	-94,3	-174,2
Total	**-146,6**	**1.735,9**	**-47,6**	**505,4**	**-470,7**	**-1.114,6**	**-144,6**	**-267,9**

Source: Copenhagen Economics (2012)

Table 6.10: Macroeconomic Effects for third countries -- experiments A-H (fixed labor supply)

	reciprocal				non-reciprocal			
	ambitious		modest		ambitious		modest	
	low spill-overs	high spill-overs	low spill-overs	high spill-overs	low spill-overs	high spill-overs	low spill-overs	high spill-overs
	A	B	C	D	E	F	G	H
Change in total exports, %								
Brazil	0,00	0,07	0,00	0,02	-0,01	0,01	0,00	0,00
India	0,00	0,03	0,00	0,01	-0,02	0,00	-0,01	0,00
Russia	0,01	-0,01	0,00	0,00	-0,01	-0,04	0,00	-0,01
Turkey	0,00	0,12	0,00	0,03	0,01	0,00	0,00	0,00
ASEAN	0,06	-0,39	0,02	-0,13	0,04	0,23	0,01	0,02
Japan	-0,02	-0,27	0,00	-0,08	-0,02	-0,08	-0,01	-0,03
Korea	-0,04	0,34	-0,01	0,11	-0,04	0,03	-0,01	0,03
Canada	0,04	1,31	0,01	0,38	0,07	0,32	0,02	0,13
USA	0,01	0,28	0,00	0,08	0,01	0,08	0,00	0,03
Other High Income	0,00	0,23	0,00	0,07	-0,03	0,13	-0,01	0,04
Rest of the World	0,01	0,07	0,00	0,02	0,00	0,01	0,00	0,00
Change in total imports, %								
Brazil	0,00	0,08	0,00	0,02	-0,01	0,01	0,00	0,00
India	0,00	0,03	0,00	0,01	-0,02	0,00	0,00	0,00
Russia	0,01	-0,03	0,00	-0,01	-0,02	-0,07	0,00	-0,02
Turkey	0,00	0,10	0,00	0,03	0,01	0,02	0,00	0,00
ASEAN	0,07	-0,45	0,02	-0,15	0,05	0,26	0,02	0,03
Japan	-0,02	-0,29	0,00	-0,09	-0,02	-0,08	-0,01	-0,03
Korea	-0,04	0,37	-0,01	0,11	-0,04	0,03	-0,01	0,03
Canada	0,05	1,33	0,01	0,38	0,07	0,32	0,02	0,13
USA	0,00	0,18	0,00	0,05	0,00	0,05	0,00	0,02
Other High Income	0,01	0,27	0,00	0,09	-0,02	0,22	-0,01	0,06
Rest of the World	0,00	0,03	0,00	0,01	-0,02	-0,02	-0,01	-0,01

Source: Copenhagen Economics (2012).

6.1.3.4. Impact on Small and Medium Enterprises under Option 2 and 3

As established by the public consultation, SMEs are particularly exposed to obstacles to investing in China, due to the high costs entailed in overcoming certain barriers. In its 2011 Communication[40] the European Commission outlined its strategy to help promote and support SMEs' economic activities outside the EU.

A European Commission survey[41] covering roughly 10,000 European SMEs suggests that only 2 percent of SMEs have invested abroad, and that 4 percent of SMEs are planning to

[40] Commission (2011) 'Small Business, Big World— a new partnership to help SMEs seize global opportunities'
[41] Commission (2010b).

invest abroad in the future. China figures among the top four destinations for international investments by European SMEs. Taking into consideration the very small group of European SMEs investing abroad in general, SME investment in China can equally be assumed to be very small though no precise figures were available through SME associations.

SMEs should benefit from the improved legal certainty provided by a uniform EU level protection agreement quite apart from any additional market access that might be attained and the administrative simplification of one single agreement at EU level could be furthermore beneficial to SMEs. An agreement would possibly also raise awareness for opportunities in China as well as provide a framework in which to pursue further cooperation that could be beneficial to SMEs.

SMEs also play a role in Chinese investment activities in Europe. The Chinese government has traditionally discriminated against and hence hampered the development of national SMEs.[42] However, a study[43] on Chinese investment in Europe reports that Chinese SMEs are increasingly entering the European economy and seeking a stock market listing in the EU. Moreover, Chinese manufacturing firms increasingly acquire low-profile, but highly specialised SMEs in the EU in order to gain access to niche knowledge and productivity-enhancing know-how. The study suggests that this form of Chinese investment in Europe actually reinforces linkages between European SMEs' suppliers and the Chinese economy.

6.2. Environmental impacts of different policy options

It is recalled that the baseline scenario assumes no changes in the current situation and takes as a basis the status quo regarding openness and legal certainty of the EU's and China's respective investment environments. The quantitative modelling tools do not permit to model the dynamic evolution of a "non-shocks" scenario. Therefore, the only available assumption is to consider that under **Option 1** there would be no impacts, neither positive nor negative.

Hence, the analysis of impact on the environment only **looks at Options 2 and 3**.

Policy Options 2: As explained, in respect of pure investment protection agreements, the existing literature remains inconclusive regarding the possibility of identifying a measurable impact even on the *volume* of FDI. Discussion of the environmental impacts of Option 2 is therefore limited to those issues explored in the section on the freedom of states to pursue legitimate policy objectives including environmental, social or human rights (See section 6.5). This relates to those new provisions that the EU could pursue in a new investment protection agreement as set out also under the problem definition section 3.3.1. These potential impacts on the environment would be the same for both Option 2 and 3. Crucially the EU would pursue the addition of a clause to recognise the explicit right of the parties to take measures to achieve legitimate policy objectives such as environmental rules as long as these are not discriminatory.

Secondly the addition of a clause, similar to the existing chapters on sustainable development in the EU's Free Trade Agreements, would be pursued that ensures that parites provide for high levels of environmental standards and do not seek to promote inward FDI by weakening or reducing domestic environmental standards or legislation.

[42] Ibid., p.57.
[43] Zhang et al (2011).

Policy Options 3: Impact of FDI (and its increase) itself on the environment: The literature is also inconclusive regarding the general impact of FDI on the environment. The impact of increased FDI on the environment in China and the EU depends on several factors including the regulatory framework, the extent of enforcement of regulations, the types of investment stimulated, the economic sectors concerned as well as the conduct of investors. Increased FDI flows theoretically affect the environment in four ways which will be assessed here.

1. **Pollution haven effect:** States might lower their environmental standards so as to attract additional investments of companies in polluting industries.
2. **Scale effect:** Increasing economic activity might trigger additional pollution.
3. **Composition effect:** An increase in investment might alter the sectoral distribution of investment and thereby affect the environmental impact of foreign investment in a host country.
4. **Technological spill-overs:** Investment might promote the diffusion of environmentally efficient technologies and thereby reduce pollution.

The combination of these four effects should determine the overall impact of an EU-China investment agreement on the environment. However, as a consequence of the predicted marginal increases in actual FDI flows in the different scenarios under Option 3, environmental impacts of an EU-China investment agreement should be limited under all options.

6.2.1. The pollution haven effect under policy Option 3

So far, it has not been possible to establish a definitive linkage between an increase in FDI and reduced environmental regulation resulting in increased pollution and/or carbon emissions[44]; although it cannot be ruled out that lower environmental standards can be an attraction in highly polluting industries. Most studies have found little support for widespread, systematic pollution haven effects.[45] Some studies on the pollution levels in China, Mexico and Brazil even clearly contradicted the pollution haven effect.[46]

The message from the public consultation was also that environmental standards are not a strong factor in the investment decision process.

Furthermore under Option 3 (like under Option 2) the EU will integrate a non-lowering of standards (environmental and labour) clause into the negotiating directives, based on the current provisions contained in the chapter on sustainable development in the EU's FTAs. This would mitigate a risk that either party could lower its environmental standards (including by not implementing them properly) to attract more FDI and thus further reduce the likelihood of a pollution haven effect.

6.2.2. The scale effect under policy Option 3:

The study by Copenhagen Economics finds that policy Option 3 should trigger only a limited increase of EU-China FDI stocks (see table 6.1 above). Bearing in mind that the absolute volume of EU investment stocks in China as well as of Chinese investment stocks in the EU

[44] Gallager and Zarsky (2007), as described in OECD (2011).
[45] OECD 2011, p 9.
[46] World Bank (2011).

is very small in comparison to other BRIC or OECD countries, even a small predicted increase is unlikely to have a potential scale effect.

Impact on global CO2-emissions

Copenhagen Economics (2012) estimates changes in CO2 emissions due to changes in the FDI framework. To the extent that EU FDI in China brings technology that is less CO2 intensive, the estimates in table 6.12 will overstate increases in emissions, and understate reductions. On the basis of current patterns, however, the net impact is estimated to be negligible (roughly -0.01 to 0.03 per cent across scenarios).

Table 6.11: Macroeconomic effects - experiments A-H

	Reciprocal				Non-reciprocal			
	Ambitious		Modest		Ambitious		Modest	
	Low spillovers	High spillovers	Low spillovers	High spillovers	Low spillovers	High spillovers	Low spillovers	High spillovers
	A	B	C	D	E	F	G	H
Change in CO2-emissions globally								
million metric tons	2.9	-2.2	0.8	-0.7	2.4	8.3	0.7	1.9
percent	0.01	-0.01	0.00	0.00	0.01	0.03	0.00	0.01

Source: Copenhagen Economics (2012)

6.2.3. The sectoral composition effect in China under policy Option 3

Further liberalisation of EU-China investment relations under policy Option 3 will not affect all economic sectors to the same degree. A change in the sectoral composition of FDI might improve or worsen the aggregated environmental impact of foreign investment in a host country such as China, where environmental legislation is not as developed as that in force in the EU and where there is such a strong focus on manufacturing. In order to assess a potential composition effect, the study by Copenhagen Economics analysed the output changes estimated in the CGE model for European enterprises in China together with a classification of "pollution-intensive" or "clean" sectors to give an indication of whether pollution might increase or decrease as a result of EU investments in China. The estimates distinguish between different liberalisation scenarios and between manufacturing (which contains more energy-intensive and thus pollution-prone sectors) and services.[47] Table 6.12 presents these estimates. It finds that Option 3 is likely to trigger twice as much FDI in manufacturing as in services under most liberalisation scenarios.

However, this does not lead to a conclusion that Option 3 would have a negative composition effect on the environment. The study differentiates between more and less polluting sectors within manufacturing, and concludes:

[47] 3% or 10% reduction of investment barriers ; unilateral or reciprocal commitment; high or low spill-overs.

- Less polluting manufacturing sectors48 would experience high increases in FDI stocks, while more polluting sectors49 would experience decreases or only minor increases in FDI stocks (see table 6.12).50
- EU manufacturing firms might substitute outdated and polluting Chinese production facilities and methods as well as introduce modern, environmentally friendly technologies in the Chinese economy (see following section on technological spill-overs).

On balance, an EU-China investment agreement should have a positive composition effect on the environment in China.

Table 6.12: Change in composition of EU manufacturing MNEs in China in experiments

	reciprocal				non-reciprocal			
	ambitious		modest		ambitious		modest	
Baseline	low spillovers	high spillovers	low spillovers	high spillovers	low spillovers	high spillovers	low spillovers	high spillovers
	A	B	C	D	E	F	G	H
"Dirty"	-7	-82	-2	-25	-58	-97	-18	-31
"Clean"	549	270	162	81	466	32	138	17
Undetermined	633	497	188	149	573	499	170	145
Total change	**1175**	**686**	**348**	**205**	**981**	**434**	**290**	**131**
% "Dirty" change relative to total change	-0,6%	-11,9%	-0,6%	-12,0%	-5,9%	-22,4%	-6,0%	-23,5%

Note: *Results for fixed closure. There is not a 100 percent match between GTAP model sectors and the ISIC codes used in Grether et al (2011). We consider the following model sectors as more polluting (denominated "dirty" in Grether's study):* 'chemicals, rubber, plastics' *and* 'petrochemicals' *and the following as less polluting ("clean"):* 'motor vehicles', 'other transport equipment', 'electrical machinery' *and* 'other machinery'. Remaining sectors cannot be classified and is "undetermined" in the table.
Source: Copenhagen Economics (2012) Own estimates from model results and Grether, Mathys, Melo (2011).

6.2.4. Technological spill-over under policy Option 3

FDI has the potential to deliver at least three types of *greening effects* due to technological spill-over.[51]

1. Transfer of clean technologies to affiliates, which are less polluting (e.g. end-of-pipe abatement) and more input-efficient compared to domestic production ("cleaner" technology).

2. Technology leapfrogging, whereby FDI transfers state-of-the-art production and pollution-control technologies to affiliates ("cleanest" technology).

3. Spill-over to domestic firms, whereby best practices in environmental management are transferred to affiliates and diffused to domestic competitors and suppliers.

[48] For instance textiles, transport equipment, general and electrical machinery, professional and scientific equipment.
[49] For instance paper production, industrial chemicals, other non-metalic mineral products, iron and steel, non-ferrous metals.
[50] The distinction between more and less polluting sectors is based on the categorization of Grether, Mathys Melo (2011) and Copeland and Taylor (2003). The sector categorization in these studies is not identical with the data used by the Consultant, which makes any conclusion tentative.
[51] Gallager and Zarsky (2007), as described in OECD (2011.).

It is unlikely that Chinese investment in the EU will lead to significant technological spill-over and greening effects in the EU given the advanced level of development technology and "green" expertise of EU companies and EU environmental legislation.

However European FDI in China promotes and should continue to promote technological spill-over. In addition, China's new green policy focus formulated in the 11th and 12th Five-Year Plans provides a favourable context for technological spill-overs and greening effects. China intends to stimulate FDI in energy and resource efficient technologies so as to pave the way for sustainable growth in China. Policy Option 3 and the linked increase in FDI flows should thus trigger some further greening effects in China.

6.2.5. Evaluation of policy Option 3

Option 3 is expected to have only a marginal impact on the environment, even after taking into account sectoral composition effects and possible changes in CO2 emission.
There is a potentially positive effect on the question of environmental standards and enforcement or non-lowering of such standards through the proposed inclusion of a clause to this end in the investment protection provisions.

Table 6.13: Environmental impact of increasing FDI flows

Type of potential impact	Option 3
Pollution haven effect	0 (+ given non-lowering of standards clause)
Scale effect	0
Composition effect	+
Technological spill-over and greening effects	+
Changes in global CO2-Emissions	0

6.3. Social impacts of different policy options

It is recalled that the baseline scenario assumes no changes in the current situation and takes as a basis the status quo regarding openness and legal certainty of the EU's and China's respective investment environments. The quantitative modelling tools do not permit to model the dynamic evolution of a "non-shocks" scenario. Therefore, the only available assumption is to consider that under Option 1 there would be no impacts, neither positive nor negative.

Hence the analysis of impact on the social and labour matters **only looks at Options 2 and 3.**

Policy Option 2: As explained previously also in the section for environmental impact, for pure investment protection agreements, existing literature remains inconclusive regarding the possibility to prove a measurable impact on the volume of FDI. As a consequence, the social or labour impact of Option 2 will be limited to the impact of investment protection on the freedom of states to pursue legitimate policy objectives including environmental, social or human rights which is analysed under the respective horizontal section **(6.6)**. It is important to point to the potential positive effect of being able to include new provisions on non-lowering of labour or social standards in an agreement and a provision that parties should strive for high levels of labour and social standards. Equally a reference to the obligation of investors to be in line with principles o f Corporate Social Responsibility can have a positive effect. These aspects are the same for Policy Option 2 and the protection part of Option 3.

Policy Option 3: Impact of FDI (and its increase) itself on the employment, welfare and social matters: As explained in the economic impact section, under Option 3, the overall expected increase in FDI flows is not predicted to be very significant and thus one would not expect very significant measurable impacts on welfare and employment. This relates back to the conservative liberalisation scenarios chosen for the economic modelling. In addition, in comparison to the baseline scenario under which EU FDI into China has been stagnating and Chinese FDI into the EU has been growing significantly from a low base, under Option 3 the expected impact would above all be an increase in EU outward FDI flows to China as a consequence to achieving further opening. Thus the next section looks particularly at the effects of EU outward FDI.

6.3.1. Impact on employment under Option 3

6.3.1.1. Impact on employment in the EU

In a study undertaken by Copenhagen Economics for the Commission in 2010 on the effects of EU outward FDI it was found that:

- The EU has so far benefitted from outward FDI in terms of both competitiveness and job creation.[52]
- For the investing firms, outward FDI is usually detrimental in the short term to employment, but beneficial in the long term. This is because a large share of outward FDI is associated with expansion into foreign markets, which drives up demand for headquarter services and leads to economies of scale. [53]
- Jobs which are being lost and created might not require the same skills. We expect the effect in the case of China to be that higher skilled worker's employment share in EU companies increase more than that of unskilled worker which are more likely to be moved to China.

Overall employment impact

The Copenhagen Economics study undertaken for this impact assessment confirms the above findings.[54] The overall employment effect in the EU of Option 3 should be positive, but marginal across all examined liberalisation scenarios. The most pronounced employment effect should materialise under the ambitious, reciprocal and high spill-over liberalisation scenario with an increase of 0.03 percent in employment.[55]

Impact on high skilled vs low skilled employment

Copenhagen Economics (2012) reports that under the liberalisation scenarios with the most pronounced investment increases and employment effects, there are marginal sectoral changes in employment for skilled and unskilled workers. Across sectors, these marginal sectoral changes, however, equilibrate so that overall no increase or decrease in employment for skilled or unskilled workers can be expected.

Impact on wages

Copenhagen Economics found that wages under Option 3 would be either unaffected or marginally positively affected in all scenarios for either skilled or unskilled workers. Wage impacts were greatest (still small) under a reciprocal, ambitious scenario with high spillovers but reaching only a 0.07 percent increase for both skill groups.

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[52] Copenhagen Economics (2010); TAC Applied Economic & Financial Research (2011).
[53] Copenhagen Economics (2012), pp.107, 114.
[54] Copenhagen Economics compiled estimates for employment effects in the EU distinguishing between 1) ambitious (10%) or moderate (3%) liberalisation; unilateral (only China liberalises) and reciprocal (EU and Chine liberalise) commitments; low spill-overs and high spill-overs (benefits arising to third country firms).
[55] Copenhagen Economics (2012).

Sector specific employment impact

The model used predicts overall impacts due to an overall liberalisation scenario. The employment impact at the sectoral level is most pronounced under the ambitious, reciprocal and high spill-over liberalisation scenario. Copenhagen Economics expects several services and manufacturing sectors to be only marginally affected (i.e. under 0.1% of sectoral employment) and predicts more visible, if still fairly low effects on the following sectors which are therefore presented here since the impact on the other sectors is so marginal or non-existant:

- +0.5 to +0.7 percent increase in the EU electronic equipment sector
- +0.5 to +0.6 percent increase in the EU motor vehicle sector
- +0.3 to +0.4 percent increase in the EU transport equipment sector
- 0.1 to -0.2 percent in the EU metal products sector
- -0.2 percent in the EU ferrous metals sector
- -0.2 percent in the EU communication services sector
- -0.4 percent decrease in the EU other metals sector

The second most pronounced effect on overall and sectoral employment numbers in the EU is expected under the ambitious, non-reciprocal and high spill-over scenario. Copenhagen Economics (2012) finds an overall positive, marginal increase of employment of slightly less than 0.03 percent and predicts sectoral changes exceeding +/-0.1 percent for the following sectors:

- +0.1 to +0.9 percent increase in the EU chemicals, rubber and plastics sector
- +0.2 to +0.7 percent percent in the EU machinery and equipment sector
- 0 to -0.2 percent in the EU metals sector
- 0 to -0.2 percent in the EU motor vehicles sector
- -0.2 percent in the EU other manufacturing sector
- -0.4 to -0.9 percent in the EU transport equipment sector
- -0.4 to -3.2 percent in the EU electronic equipment sector

Under both scenarios, the sectors for which a negative albeit small effect can be noted tend to correspond to the sectors where total output is also expected to be negatively impacted. Appendix 4 of the Copenhagen Economics 2012 study provides a full overview of the sectoral results.

In conclusion, Option 3 under the various scenarios tested, is expected to have only a very marginal impact on either overall or sectoral employment, on unskilled or skilled workers as well as wages in the EU.

6.3.1.2. Impact on employment in China

Given the existing level of openness in the EU and the level of restrictiveness in China, further opening should lead first and foremost to an increase in EU FDI into China. Copenhagen Economics[56] indicates that inward FDI has a positive impact on employment in general and in China in particular. It finds that European investments in China are particularly labour intensive in comparison to European investments in the rest of the world. Consequently, Option 3 should have a positive impact on employment in China. Research

[56] Copenhagen Economics (2012).

also suggests that foreign investors provide better labour standards, pay higher wages and thereby increase the aggregated real income in the host country. Research on China confirms this positive impact of employment.

Conversely, the small increase of Chinese outward FDI predicted under Option 3 is likely to have an insignificant impact on employment in the EU. Indeed, Chinese firms invest in the EU predominantly to acquire brands, technologies and distribution channels and do not compete with domestic investment opportunities and job creation.[57]

6.3.2. Impact on labour conditions under Option 2 and 3

Section 6.6 below analyses the general question of the relationship between investment standards and environmental, social or labour standards. As the section explains, Options 2 and 3 are expected to have a neutral to positive impact on labour conditions given the intention to include a non-lowering of standards clause in the investment protection provision as well as a reference to corporate social responsibility as opposed to the currently existing BITs that do not include such references and would continue under the baselines scenario.

As regards the baseline scenario, China has ratified only four of the eight core ILO Labour Conventions.[58] Workers in China do not have the right to organise in trade unions of their choice and the right to collective bargaining is restricted. The right to strike was removed from the Chinese Constitution in 1982. Discrimination on the basis of gender is prevalent, as well as institutionalised discrimination against migrant workers from rural areas. Child labour is a serious problem in China. In addition, while forced labour is prohibited in China in general, it does occur in commercial enterprises. Moreover, forced labour is legally authorised in prisons and in re-education through labour camps.

The theoretical literature on labour conditions and trade and investment agreements does not present a conclusive picture. On balance however, empirical studies tend to lend support to the view that MNEs pay on average higher wages and provide better working conditions than local firms. In consequence, increased EU investment in China should benefit Chinese workers to the extent of course that China enforces labour legislation and strives to improve its standards in areas where problems persist today. [59]

The EU actively pursues the question of Corporate Social Responsibility in its chapter on sustainable development in FTAs and includes references to the OECD Guidelines for Multilateral Enterprises in future EU investment agreements so as to recognise the need to respect human rights, the environment and good quality working conditions.[60] Although China is not yet an adherent to the OECD Guidelines, it would be desirable to negotiate the strongest possible CSR clause in an investment agreement. Such references would enable the parties to the agreement (China and the EU) to engage in cooperation and dialogue on CSR matters which also has a bearing on labour conditions.

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[57] Financial Times (2011).

[58] It has ratified the ILO Conventions on equal remuneration and discrimination, on the worst forms of child labour and the ILO Convention on minimum age. It has not ratified either of the core ILO Conventions on freedom of association and collective bargaining. It has also not ratified the core ILO Conventions on forced labour. For analysis, see: International trade Union Confederation (ITUC) (2010).

[59] Copenhagen Economics (2012), p. 143.

[60] European Parliament resolution of 6 April 2011 on the future European international investment policy (2010/2203(INI)), paras 27-28.

As regards the EU, an increase of Chinese FDI under Option 3 would not have any impact on labour conditions since companies established in the EU need to comply with all relevant legislation in the EU.

6.3.3. Impact on social inclusion under Option 2 and 3

The impact of the different policy options on social inclusion and protection of particular groups, gender equality, equal treatment and opportunities, non-discrimination, access to and effects on social protection, health and educational systems as well as public health and safety can be considered as broadly neutral. Neither Option 2 nor Option 3 directly affect certain groups of individuals, such as the most vulnerable or the most at risk of poverty, children, women, elderly, the disabled or ethnic, linguistic and religious minorities.

Table 6.14: Social impact of EU-China investment agreement under Option 3

	Option 3	
	EU	**China**
Impact on employment	0	+
Impact on wages	0	+
Impact on labour conditions	0 to + given inclusion of non-lowering of standards clause	+
Impact on social inclusion	0	0

6.4. Human rights impact under Option 2 and 3

In the public consultation several stakeholder expressed an opinion on human rights. The Austrian Federal Chamber of Labour stated that an EU-China investment agreement should reconcile the rights of investors with the policy space of states to allow for the protection and the promotion of human rights. The NGO APPRODEV emphasized that human rights should be included in the impact assessment process.

Respondents also mentioned a number of issues in relation to human rights that might require specific attention in the context of an EU-China investment agreement, some of which relate to social and labour standards: freedom of expression, freedom of the media (press and access to websites in particular), child labour, respect of labours laws and standards, better conditions for NGOs and the civil society, respect of the due process of law.

Different **types of rights** can be identified as relevant:

Investors' rights: Investment protection agreements directly impact rights of investors and share a common heritage with international human rights law, which protects the rights of natural and legal persons against *undue* interference by States.[61] (protection of property[62], right to have made good any damages, right to effective legal remedy to enforce such rights).

[61] Nelson, (2011), p.28; Jacob (2010), p 10.

[62] The right to property is for example expressly contained in the Charter of Fundamental Rights of the European Union: Article 17: The right to property: *1.Everyone has the right to own, use, dispose of and bequeath his or her lawfully acquired possessions. No one may be deprived of his or her possessions, except in the public interest and in the cases and under the conditions provided for by law, subject to fair compensation being paid in good time for their loss. The use of property may be regulated by law in so far as is necessary for the general interest.*
2. Intellectual property shall be protected.

Rights of actors other than investors: Investment protection agreements can indirectly impact a large number of rights[63] of actors (citizens, employees etc) other than investors. These rights include both civil and political rights, as well as social, economic and cultural rights.

The fundamental standards of investment protection agreements are built on a balance between, on the one hand, the treatment of property and of the rights of investors, and, on the other, the protection of human rights of the population.

The same balance is to apply when implementing obligations arising out of international investment agreements on the one hand, and human rights law on the other. Hence, investment agreements do not alter *by themselves* the balance which is anyway found in the legal order of democratic States. However it is important to confirm this fact in EU investment agreements, to avoid uncertainty concerning the fact that arbitral tribunals can take such obligations into account.

Hence, the overall direct impact on human rights under either Option 2 or 3 is neutral to positive since it strengthens the already existing protection of the right to property of investors and does not negatively impact any other rights of actors other than investors.

In addition, the EU is committed through its political dialogues with China to raising human rights issues with China. As stipulated under Article 21 of the Treaty on the European Union, the external action of the EU and thus the common commercial policy has to be guided by the principles which it seeks to advance in the wider world including democracy, rules of law and the universality of human rights. A proposal for negotiating an EU-China investment agreement under policy Option 2 or 3 will have to be consistent with the EU's policies and due consideration will be given to maintaining the balance between investors' rights and human rights of the population described above.

The EU seeks to include a human rights clause in the EU-China Partnership and Cooperation Agreement, which is under negotiation, and provides the framework in which questions of respect, promotion and protection of democratic principles, human rights and fundamental freedoms and sustainable development proposed by the EU are negotiated. This is in line with the EU policy of including a human rights clause in all political framework agreements that accompany Free Trade Agreements. The purpose of such a clause is twofold. First, it eliminates any doubts about whether or not both parties have the right to raise issues of human rights violations by the other party. Second, together with the suspension clause it allows either whole or partial suspension of the political framework agreement in response to grave violations of human rights. The human rights clause refers to international standards binding on the parties, including the Universal Declaration of Human Rights and UN conventions on human rights ratified by both parties.

[63] Rights include for example all the rights under the UN Conventions on Human Rights ratified by all EU MS and the Charter of Fundamental Rights of the European Union, see Mann (2009), p.10.

6.5. <u>The impact of investment protection under Option 1,2 and 3 on the right to regulate to pursue legitimate policy objectives (environmental, social, labour, human rights)</u>

The question of a potential direct or indirect impact of an EU-China investment agreement on the right of states to pursue legitimate public policy objectives is a cross-cutting issue for the various impacts analysed so far. The European Parliament[64] and a number of stakeholders have expressed concerns that investment protection clauses, in particular investor-to-state dispute settlement (ISDS), could hinder the right of governments to legislate to pursue legitimate public policy objectives in areas such as the environment, labour rules, social matters and human rights, (including their obligations under both national and international agreements on such matters).) ISDS procedures allow third country investors to seek independent arbitration towards the host States.

A careful consideration of these concerns against existing practices and case law found that <u>non-discriminatory regulation in the public interest is fully consistent</u> with the standards contained in a protection agreement. Indeed, when the objective pursued by public intervention is a legitimate public policy interest, a tribunal must assess whether such a measure was proportionate; whether a restriction of the rights of an investor was justified or not; and whether (for example) a direct or indirect expropriation has occurred (in which case an investor would be entitled to compensation).[65] With regard to indirect expropriation, case law confirms that a "taking" or a very significant impairment of the value of an investment must be demonstrated in order to be entitled to compensation.

The right to pursue legitimate public policy objectives is currently reflected in the EU's practice regarding investment (establishment) in Free Trade Agreements and the WTO agreements through specific provisions. The negotiating directives for an EU-China investment agreement will provide to follow the EU's FTA practice and include explicit provisions restating the right to regulate for legitimate public policy concerns.

6.5.1. <u>Policy Option 1: Baseline</u>

None of the existing 25 Member State BITs with China contain language specifically addressing the question of the right to regulate, nor specific provisions on social or environmental issues. Yet, even in the absence of specific provisions, so far there is no indication that the existing BITs have unduly restricted Member States' (or China's) policy space to legislate in furtherance of legitimate public policy objectives. On balance, the potential negative impact of this situation on the right to regulate as well as indirectly on the rights of actors other than investors would be very limited.

6.5.2. <u>Policy Options 2 and 3</u>

As indicated above, there is no clear structural or legal impediment under investment protection agreements for States to pursue public policy objectives. In addition, the negotiating directives for an EU-China investment agreement would include specific language on the respect of human rights and the "right to regulate", as well as a reference to corporate

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[64] See European Parliament (2011); Seattle to Brussels Network (2010), p.9.

[65] Article 17: Everyone has the right to own, use, dispose of and bequeath his or her lawfully acquired possessions. No one may be deprived of his or her possessions, except in the public interest and in the cases and under the conditions provided for by law, subject to fair compensation being paid in good time for their loss. The use of property may be regulated by law in so far as is necessary for the general interest.

social responsibility in line with the EU FTA practice, as well as additional guidance to arbitration tribunals on the rules of interpretation in dispute cases. With the inclusion of such appropriate language the impact of Options 2 and 3 on human rights in general would be neutral to positive.

The table below shows an overview of how an agreement under Option 2 or 3 would impact these rights.

Table 6.15: Selection of rights affected/potentially affected by an investment protection agreement under Option 2 or *3*[66]

Types of rights	Category affected	Direct Effect	Indirect Effect
The right to property and to have made good damages	Investor	+	0
Civil and political rights and social, economic and cultural rights	Citizens/employees	0 (or + in case of explicit language)	+ (In case of explicit language)

An EU-China investment agreement could thus in principle combine the positive direct impact on protection for investors of the newer generation of Member State investment protection agreements with China, with clauses mitigating the potentially negative indirect effect of investment protection agreements on the issue of public policy space including the need for the EU and China to legislate in furtherance of the rights of actors other than investors.

Table 6.16: Possible impact of an EU-China investment agreement on right to regulate

Policy Option	Direct impact	Indirect impact	On balance
(1) No EU agreement	The situation of 25 Member State BITs persists, with only some providing for the possibility of resorting to investor-State arbitration.	For existing BITs containing the possibility to resort to arbitration, the potential indirect negative impact is deemed to be very limited but is not mitigated by appropriate language reserving the right to regulate of the State.	The existing situation is far from ideal. Many European investors cannot directly invoke the rights enshrined in BITs with China. For those agreements where this is possible, the positive impact of investor-State arbitration on investment protection is counterbalanced by the absence of appropriate language on right to regulate of the State.
(2) & (3) EU-China investment agreement	There is a positive direct impact on the investment protection rights of investors, including the right for all investors to adequate legal remedies. (thus positive for those that do not have this now and neutral for those that do)	Even if potential indirect negative impact on the right to regulate caused by investors resort to arbitration is deemed to be very limited it will be further mitigated by appropriate language reserving the right to regulate of the State and clarifying rules of interpretation in ISDS	The positive impact of an EU-China investment on the rights of investors is ensured by improving legal certainty and clarity as to the rights of investors and also affirming the right of the state to pursue legitimate policy objectives.

[66] The signs "+" (positive effect), "-" (negative effect) and "0" (no effect) in the table are to be seen as a comparison with option 1.

6.6. Administrative and budgetary impacts of option 2 and 3

6.6.1. Administrative impact

The administrative impact can be defined as the costs incurred by enterprises and public authorities in meeting legal obligations to provide information on their action or production, either to public authorities or to private parties. The administrative efforts necessary for implementation are different for each of the policy options. The baseline scenario does not require or assume any kind of additional administrative burden.

The complexity of implementation depends mostly on the extent of elimination of the cost of existing investment barriers, which in the case of China may require legislative or administrative procedures. However, it should be pointed out that the replacement of 25 current BITs with one single EU level agreement may also entail simplification for Chinese administration and companies. Equally, an EU agreement and related procedures entail a degree of simplification for EU companies. As regards administrative burden in the EU, the conclusion of an investment agreement will require a process of approval by Council and European Parliament and implementation.

6.6.2. Budgetary impact

Under **policy option 3 market access** provisions would have no direct budgetary impact for the EU.

However certain provisions on **investment protection** under **both policy Option 2 and 3** could have an incidence on the EU budget in the following areas:

- the management of investor-State disputes arising under the agreement, including arbitration costs and legal fees;
- the possible need to pay compensation for damages as a result of the breach of the investment protection agreement.

DG Trade is currently working on a draft proposal on the allocation of financial responsibility for investor-to-state disputes. The basic idea is that financial responsibility for such costs should follow the source of the treatment about which the investor complained. Therefore, should the treatment challenged by a Chinese investor be exclusively afforded in a Member State, the Member State in question should be liable for the costs flowing from the dispute settlement. Similarly, where the treatment of which an investor complained is afforded by the institutions of the EU (including where the measure in question was adopted by a Member State in compliance with EU law), financial responsibility should be borne by the Union and thus be paid out of the EU budget. Where the Union acts as respondent in a dispute concerning Member State treatment and the claimant is successful, the costs relating to the dispute will be paid from the EU budget, which will then be reimbursed by the Member States.

In principle, the same financial risks pertain to the investment protection provisions in an EU-China investment agreement as to existing Member State BITs. However, a novel element of an EU-China BITs would be that the management costs of any such disputes and the payment of the final award would in some circumstances be borne by the EU.

Estimating Investor-to-State Dispute Settlement Costs

According to academic research which looked at investment treaty arbitration in general, there were 102 publicly available awards in some 82 cases as of mid 2006.[67] The claims originated from investors established in up to 25 countries, with the majority coming from the USA, Canada, Netherlands and Italy.[68] These cases were brought against just over 60 countries, a majority of which were developing countries with only around 14 cases against developed countries.[69] It is thought that governments won over 50% of the cases, if they lost, the average amount awarded was US$10 million.[70]

The majority of cases brought against EU Member States were by investors from USA, Canada, Switzerland and Norway. Other countries included India, Argentina, Croatia, Russia and Israel. From the publicly available data there were 21 investment arbitration cases brought against EU Member States by third-country investors.[71] Out of these 21 cases, EU Member States were unsuccessful in defending their measures in only two cases, the rest were either settled or won by the EU Member State. The two cases which were lost were *Maffezini v Spain*[72] and *Lauder v Czech Republic*[73].

Out of these cases only in the *Maffezini* case the defending state (Spain) had to pay compensation of approximately €350,000 euro (ESP 57,541,265). In the *Lauder* case, the Czech Republic was not required to pay any compensation, despite losing on a point of law.[74] The picture may be incomplete, as in cases which were settled, States could have paid a certain sum to the investor. As the terms of such settlement are usually kept confidential it is impossible to ascertain their frequency and magnitude.

In case of investment treaty arbitration the amount of legal costs as well as tribunal costs and expenses represent a significant expense for each party involved. Indeed, it has been observed than on average, the cost of investment treaty arbitration equals more than 10% of an average award.[75] According to academic research average tribunal costs and expenses (TCE) amount to just over US$ 580,000[76], with States paying on average approximately US$ 291,500[77]. Average private legal costs were calculated to be approximately US$655,000, ranging from US$22,000 to almost US$ 2,990,000.[78] However there have been some exceptional cases involving EU Member States where up to US$ 12.7 million had to be paid in arbitration costs.[79]

[67] Franck (2008), p. 22.
[68] Ibid., see fn.1, p. 27.
[69] Ibid., see fn. 1, p. 31.
[70] Franck (2009), p. 447.

[71] See http://italaw.com/alphabetical_list_respondant.htm and http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=ListCases
[72] *Emilio Augustin Maffezini v. The Kingdom of Spain*, Case no. ARB/97/7, http://italaw.com/documents/Maffezini-Award-English.pdf
[73] *Ronald S. Lauder v. The Czech Republic* (2001), http://italaw.com/documents/LauderAward.pdf
[74] see the Award of 3 September 2001, at page 74-5, http://italaw.com/documents/LauderAward.pdf
[75] Franck (2011), p. 477
[76] Ibid., see fn. 10 , p. 812
[77] Ibid., see fn. 10, p. 812
[78] Ibid., see fn. 10, p. 812
[79] For example the losing investor in *Plama v Bulgaria*, see the Award of 27 august 2008 pp. 97-98, available at: http://italaw.com/documents/PlamaBulgariaAward.pdf ; see also Franck,Franck (2011), see fn. 10 at p. 785.

Potential financial impact of an EU-China Investment Agreement
With regard to an EU-China Investment Agreement, although the potential costs that could be borne by the EU from investor-to-state dispute settlement cannot be quantified at this stage, there are factors which can assist in estimating the probability of the EU facing an investor-to-state dispute settlement claim.

Firstly, the likelihood of investor-to-state dispute settlement could be considered to be directly proportional to the volume of investment flows from China into the EU. In 2010, despite a generally upward trend over the last 10 years, foreign direct investment from China into the EU made up only 4% of the total FDI from China into third countries and 1.7% of total FDI into the EU.

Secondly, China has entered into BITs with all Member States, except Ireland and the aim of an EU-China Investment Agreement would be to consolidate the investment protection offered by the two parties. No case has ever been brought against an EU Member State by a Chinese investor under any of the BITs. In fact, notwithstanding China having BITs with 128 countries, there is only one known case of a Chinese investor relying on a BIT for relief (against Peru).[80]

Given the above considerations and the fact that Member States have been successful in defending 95% of the (known) cases in which they have been the respondent, there is no reason to believe, on the basis of the currently available evidence and experience, that the conclusion of an EU-China Investment Agreement will lead to a significant increase in disputes nor to a significant increase in compensation pursuant to such disputes. Therefore, it appears likely that such an agreement will have a marginal impact on the Union budget, as compared to the baseline scenario.

7. <u>COMPARISON OF OPTIONS</u>

This section compares the three Options assessing how they would meet the objectives outlined in chapter 4 and whether they are politically feasible.

7.1. <u>Overall evaluation of each Option</u>

Baseline – the "do nothing" Option
The baseline Option of "doing nothing" does not achieve any of the specific and operational objectives since it continues the status quo with no policy tools available to address the current imbalances in the EU-China investment relationship. No progress could be expected on further market access and improvement of investment conditions in the near or medium term. As regards investment protection, the patchwork described under section 3.3.1 would persist.
The impact of this Option would be negative if the ongoing bilateral negotiations between China and certain third countries resulted in more favourable conditions for investors from these countries. Equally the EU's ongoing negotiations could result in increases of FDI to/

Other instances included a loosing state having to pay in costs US$ 7.7 million in *ADC v Hungary*, see the Award of 2 October 2006, at p. 103, available at: http://italaw.com/documents/ADCvHungaryAward.pdf
[80] Tza Yap Shum v. Republic of Peru (ICSID Case No. ARB/07/6) http://italaw.com/documents/TzaYapShumAward.pdf

from the partner countries to the detriment of EU-China investment flows and (potentially) of future trade flows.

At the EU-China Summit in February 2012 leaders agreed that *"a rich in substance EU-China investment agreement would promote and facilitate investment in both directions. Negotiations towards this agreement would include all issues of interest to either side, without prejudice to the final outcome. They agreed to work towards the start of the negotiation as soon as possible."* Given the political understanding reached as well as the strong calls from stakeholders to pursue an investment policy that tries to actively remedy the current shortcomings of the framework for EU-China investment relations, the "do nothing" scenario seems to be both economically undesirable, and politically unacceptable.

Baseline – "do nothing"
Overall suitability: Cannot achieve objectives – politically unacceptable given the stated aims of both parties

Option 2 Standalone investment protection agreement replacing the 25 existing BITs
Under this Option two of the four specific objectives could be (partly) achieved, in particular the improvement of the level of protection of EU investment in China and the objective of improving legal certainty. Both of these are important components for investors. This Option could also allow to address some issues not sufficiently addressed under existing BITs such as the non-lowering of standards, CSR or the role of state-owned enterprises. In this respect Option 2 could also be seen to have a neutral to positive effect on certain aspects of environmental, social and labour standards as well as on fundamental rights and on the right of States to regulate in order to pursue legitimate policy objectives.

However, this Option would not address market access barriers to establishment and would not be expected to have an effect on actual FDI flows. Such an agreement would be politically more palatable to the Chinese side, which has declared its main interest to be investment protection. As such a negotiation of a pure investment protection agreement would be less complicated than the scenarios involving market access. However, the EU's main problem relates to the unlevel playing field regarding investment access and treatment in China which such an agreement would not address. Agreeing to negotiate a pure investment protection agreement would also mean losing the remaining leverage arising from China's keen interest in a protection agreement to achieve some concessions regarding access and treatment of prospective investors.

Option 2
Impact: Mixed: positive as regards investment protection; neutral as regards lowering of barriers and increase of FDI flows
Overall suitability: Can partially achieve objectives; politically feasible but does not satisfy key EU objectives

Option 3 – standalone investment agreement combining market access and protection
This policy Option is the only one that can address all the objectives identified and thus help resolve the main problems of the current EU-China investment relationship. It would achieve the same objectives as Option 2 with regard to increased legal certainty under investment protection. Moreover, this is the only realistically pursuable policy Option that would address

the current imbalance regarding openness to FDI in China – even though a cautiously realistic approach needs to be maintained in relation to expected concessions on market access.
Under this Option both China and the EU would stand to gain as regards economic growth, competitiveness, productivity and employment, even on the basis of the relatively modest and conservative assumptions retained.

The potential impacts on the environment resulting from an increase of FDI flows would be marginal, with a positive overall impact. Concerning employment, there is no evidence that increases in EU outward FDI have led to significant losses of jobs in the EU – whereas inward FDI is directly linked to the creation or maintenance of employment.

As with Option 2, this Option would have the potential for neutral to positive impact on questions relating to the right of states to regulate to pursue legitimate policy objectives in areas such as environment, employment, social rules and human rights.

Option 3
Impact: Positive
Overall suitability: Goes furthest to achieving the objectives of both parties

Table 7.1: Potential effects of Options in comparison with the operational objectives

Objectives	Option 1	Option 2	Option 3
Progressive abolition of restrictions to FDI	0/-	0	++
Economic growth	0/-	0	++
Job creation and welfare	0	0	++
Competitiveness of the EU	0/-	+	++
Improving legal certainty regarding treatment of EU investors in China	0/-	+ (Partly positive but only regarding post-establishment)	++ (Positive potential for both pre- and post establishment)
Improving the protection of EU investments in China	0/-	++	++
Reducing barriers to investing in China	0/-	0	+
Increasing bilateral FDI flows	0	0	+ (positive potential)
Political feasibility	Feasible	High feasibility on both sides	Feasibility high on EU side with more reluctance on Chinese side
Overall expected impact (Effectiveness)	Neutral	Some positive impact could be expected for part of the objectives	Positive impact on investment protection and some positive impact achievable on market access related matters.
Efficiency	Neutral	+	++
Coherence with overarching EU policy objectives	0	+	++

Option 1 ("do nothing") included as baseline. Options 2 and 3 estimated against Option 1. Options 4 and 5 not included as not feasible

7.2. Identification of preferred option

The preferred Option for the EU would be to pursue a standalone investment agreement seeking to combine both investment protection with market access elements (Option 3). China's stated preference has been a pure investment protection agreement to replace today's patchwork of agreements (Option 2). However, it has agreed at the 14th EU-China Summit that it would be willing to pursue a negotiation covering all issues of interest to either side, and has conceded in bilateral discussions that this entails not only protection but also market access. China maintains interests in possible EU concessions outside the area of the consolidation of the existing BITs. For example, it has a vested interest in achieving a binding of EU FDI openness in a bilateral agreement in order to provide a safeguard against protectionist sentiments regarding FDI from China.

8. MONITORING AND EVALUATION

Monitoring and evaluation of the specific objectives will have to follow several paths since not all objectives are equally measurable/quantifiable and some may depend on a qualitative evaluation based for example on feedback from stakeholders obtained through a survey. Some of the objectives will relate not only to the implementation of legislation and rules, but also to their formulation. In such cases, information can also be gathered from legal sources and feedback from the ground, as is currently the case when monitoring the investment environment and barriers in China.

Achievement of these objectives will depend on the outcome of the negotiations with China. In order to maintain and update the analysis of developments in on-going trade negotiations, DG TRADE has also developed a Trade Sustainability Impact Assessment (Trade SIA), which is a policy tool for *ex ante* assessment of the economic, social and environmental implications of a trade negotiation. They have been applied to all the EU's major multilateral, regional or bilateral trade negotiations since 1999. A TRADE SIA was conducted for the EU-China PCA negotiations and finalised in 2008. DG Trade will assess how best to ensure that the negotiations on investment With China are properly supported by ongoing policy and analysis..

In line with the commitments made in the 2010 Communication on Trade, Growth and World Affairs, there will be rigorous ex post evaluation of the effects of any investment agreement concluded with China at an appropriate time interval after its implementation.

Table 8.1: Overview of objectives and monitoring indicators

	General Objectives	Indicators of progress towards meeting objectives
1	Progressive abolition of restrictions on FDI	Relative and absolute percentage change of bilateral investment flows and overall FDI trends (in particular in comparison with other strategic trade partners and the BRIC states) Changes in legislation Commitments taken in an agreement Ranking of China and EU in FDI restrictiveness indexes (e.g. OECD)
2	Economic growth	Relative and absolute percentage change of bilateral investment flows Percentage change in GDP & national income
3	Job creation and welfare	Percentage changes in employment & wages
4	Competitiveness of the EU	Placement of EU MS in global competitiveness rankings

	Specific Objectives	
1	Improving legal certainty regarding treatment of EU investors in China	Changes in legislation Commitments in agreement Increase of transparency/availability of information Business survey results
2	Improving the protection of EU investments in China	Changes in legislation Commitments in agreement Increase of transparency/availability of information Business survey results
3	Reducing barriers to investing in China	Changes in legislation Commitments in agreement Increase of transparency/availability of information Business survey results Ranking of China in restrictiveness surveys
4	Increasing bilateral FDI flows	Relative and absolute percentage change of bilateral investment flows
	Operational Objectives	
1	Provide EU investors with better market access and effective non-discrimination for FDI	Commitments taken (e.g. Number of sectors opened to foreign investors, number of barriers detected) Changes in legislation relating to foreign investors Increase of transparency/availability of information Business survey results Ranking of China in restrictiveness surveys
2	Increase transparency & predictability of controls/screening of EU FDI into China	Better availability of information Changes in legislation (e.g. time periods and procedures)
3	Seek highest level of uniform standards of protection for European investors in China	Changes in legislation relating to foreign investors Increase of transparency/availability of information
4	Ensure investment protection standards include strong protection of intellectual property rights.	Number of complaints by EU companies about IPR protection Business surveys
5	Seek to increase EU's attractiveness as Chinese FDI destination	Relative and absolute percentage change of bilateral investment flows Business surveys
6	Increase transparency of administrative procedures and implementation of rules for FDI	Increase of transparency/availability of information
7	Creation of enquiry points and one-stop shops for investors	Increase of transparency/availability of information Number of investors contacting enquiry points
8	Improve playing field vis-a-vis Chinese state owned enterprises/remedy effects of loans and subsidies.	Business surveys
9	Ensure right of the parties pursue legitimate public policy objectives	Commitments in agreement Monitoring of any disputes under the agreement
10	Provide for non-lowering of standards clause	Commitments in agreement Changes in legislation/practice Business survey results
11	Include a reference to Corporate Social Responsibility	Commitments in agreement Business and stakeholder surveys Corporate reporting
12	Ensure enforcement through adequate dispute settlement including out of Court arbitration.	Commitments in agreement Monitoring of any disputes under the agreement Business surveys/complaints by EU companies

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10. ANNEXES TO THE DRAFT IMPACT ASSESSMENT REPORT ON EU-CHINA INVESTMENT RELATIONS, 7 SEPTEMBER 2012

ANNEX 1: Bilateral investment treaties between EU Member States and the People's Republic of China

ANNEX 2: Abbreviations and glossary

ANNEX 3: Methodological annex

ANNEX 4: Minutes of the 6th Impact Assessment Steering Group Meeting

ANNEX 5: Summary of contributions to the European Commission's public consultation on "The future investment relationship between the EU and China"

ANNEX 6: Executive Summary of Study by Copenhagen Economics

ANNEX 1: Bilateral investment treaties between EU Member States and the People's Republic of China

EU Member State	Date of signature	Date of entry into force	Minimum period of validity in years	Notification period after expiry in years	Continuous protection after termination in years	End of protection for established investments, if BIT cancelled the soonest possible
Austria	12/09/1985	11/10/1986	10	1	15	2028
Belgium & Luxemburg	6/6/2005	1/12/09	10	1	10	2029
Bulgaria	27/6/1989	21/8/1994	10	1	15	2028
Cyprus	***17/1/2001***	***29/4/2002***	***10***	***1***	***10***	***2023***
Czech Republic	8/12/2005	1/9/2006	10	1	10	2026
Denmark	***29/4/1985***	***29/4/1985***	***10***	***1***	***10***	***2023***
Estonia	2/9/1993	1/6/1994	10	1	10	2023
Finland	15/11/2004	15/11/2006	20	1	20	2046
France	26/11/2007	20/8/2010	10	1	15	2035
Germany	1/12/2003	11/11/2005	10	1	20	2035
Greece	25/6/1992	21/12/1993	10	1	20	2033
Hungary	***29/5/1991***	***1/4/1993***	***10***	***1***	***10***	***2023***
Italy	28/1/1985	28/8/1987	10	1	15	2028
Latvia	***15/4/2004***	***1/2/2006***	***10***	***1***	***10***	***2026***
Lithuania	***8/11/1993***	***1/6/1994***	***5***	***1***	***10***	***2023***
Malta	***22/2/2009***	***1/4/2009***	***10***	***6 months***	***10 year periods***	***2019***
Netherlands	26/11/2001	1/8/2004	15	5 year renewal, 6 months notification	15	2034
Poland	***7/6/1988***	***8/1/1989***	***10***	***1***	***10***	***2023***
Portugal	9/12/2005	26/7/2008	10	1	10	2028
Romania	***16/4/2007***	***1/9/2009***	***5***	***1***	***10***	***2024***
Slovakia	***7/12/2005***	***25/5/2007***	***10***	***1***	***10***	***2017***
Slovenia	***13/9/1993***	***1/1/1995***	***5***	***1***	***10***	***2023***
Spain	14/11/2005	1/7/2008	10	1	10	2028
Sweden	27/9/2004	-	15	1	15	-
United Kingdom	15/5/1986	15/5/1986	10	1	15	2028

The ten agreements in italic could be terminated the earliest.

ANNEX 2: ABBREVIATIONS AND GLOSSARY

ASEAN	Association of Southeast Asian Nations
BIT	A BIT is an agreement through which two States encourage and protect reciprocal investment. The legally binding provisions of these BITs ("standards of protection") typically include fair and equitable and non-discriminatory treatment up to granting full national treatment to investors and their investments, protection from unlawful expropriation, free transfer of funds and full protection and security. Since investment is usually defined in a broad, asset based manner, protection thus also extends to intellectual and industrial property rights. On top of this, the majority of BITs also offer investors the possibility of direct recourse to independent international arbitration against the host country concerned when their rights under the treaty have been violated ("investor-to-state dispute settlement"). This avoids the need for investors to sue host States in their own domestic courts
BRICs	Acronym for group of emerging markets consisting of Brazil, Russia, India and China.
CGE	Computable General Equilibrium.
DDA	Doha Development Agenda
EJV	Equity Joint Venture
FATS	Foreign Affiliates Statistics (Eurostat)
FDI	Foreign Direct Investment. An investment qualifies as FDI, if the investor holds a long-term interest in the affiliated enterprise abroad and actively participates in its management. The OECD, IMF and ECJ consider an investment as FDI, if the investor holds ca. 10% of voting rights and/or shares in the affiliated enterprise. Investments, which do not qualify as FDI, are considered as portfolio investments.
FTA	Free Trade Agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
ICSID	International Centre for the Settlement of Investment Disputes. ICSID is an institution of the World Bank Group, which provides mediation and arbitration for disputes between member states and foreign investors.
IIA	International Investment Agreement
ILO	International Labour Organisation
IMF	International Monetary Fund
ISDS	Investor-to-State Dispute Settlement. ISDS is the standard resolution mechanism for investment disputes between host states and foreign investors. ISDS enables investors to seek compensation in case of mistreatment and/or expropriation through a host state, while circumventing potentially biased host state courts. ISDS is normally held under ICSID, UNCITRAL or Stockholm Chamber of Commerce rules.
ITUC	International Trade Union Conference
MAI	Multilateral Agreement on Investment
MFN	Most Favoured Nation clause: "Most Favoured Nation" MFN treatment denotes the principle of not discriminating between one’s trading partners. Thus a level of treatment accorded by one state to another in international trade means that the country which is the recipient of this treatment must, nominally, receive equal trade advantages as the "most favoured nation" by the country granting such treatment.
MNE	Multinational Enterprises

MOFCOM	Chinese Ministry of Commerce
M&A	Merger and Acquisition
NGO	Non-governmental Organisation
OECD	Organisation for Economic Cooperation and Development
PCA	Partnership and Cooperation Agreement
SIA	Sustainability Impact Assessment
SMEs	Small- and Medium-sized Enterprises
TRIMs	Agreement on Trade-Related Investment Measures
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organisation

ANNEX 3: METHODOLOGICAL ANNEX

This annex reviews the methodological aspects of the quantitative analyses on the potential economic impact of the agreement discussed in the Copenhagen Economics (2012) report. Such analyses have been used as a basis for chapter 6. In details, the first paragraph will describe the econometric methodology used to identify the effect on FDI stocks while the following section will focus on the computable general equilibrium (CGE) framework used to identify the macroeconomic effects (welfare, trade and prices) and the quantification of the investment barriers done to be used in such model. The section on the CGE also explains how the general framework has been extended to model the activity of MNEs.

1. Effect on FDI stocks: the gravity model approach

A gravity model was used to quantify the impact of an EU-China BIT on the stock FDI between the two countries. Investment barriers are measured by the Copenhagen Economics index of perceived restrictiveness based on survey data as described in Box A.1.

Box A.1 Description of the Copenhagen Economics index of perceived restrictiveness

The database on perceived barriers to trade and investment has been compiled during the period 2009-2012 through three studies carried out by Copenhagen Economics and others on behalf of the European Commission:

- Copenhagen Economics and Ecorys (2009): Non-Tariff Measures in EU-US Trade and Investment – An Economic Analysis
- Copenhagen Economics (2010): Assessment of Barriers to Trade and Investment between the EU and Japan
- Copenhagen Economics (forthcoming): EU-China Investment Study

All three studies encompassed a survey, where respondents were asked the same questions related to the level of restrictiveness of the foreign country compared to the home country. In this study, the questions asked were:

"Consider investing in your domestic market in your sector. If 0 represents a completely 'barrier free investment' environment, and 100 represents an entirely closed market due to investment barriers, what value between 0 - 100 would you use to describe the overall level of restrictiveness of your home market to your operations in this sector? (Please write a number between 0 and 100)"

And the following question was asked for China and other partner countries:

"Consider investing in China, keeping in mind your domestic market. If 0 represents a completely 'barrier free investment environment, and 100 represents an entirely closed market due to investment barriers, what value between 0 - 100 would you use to describe the overall level of restrictiveness of the Chinese market to your investments in this sector? (Please write a number between 0 and 100)"

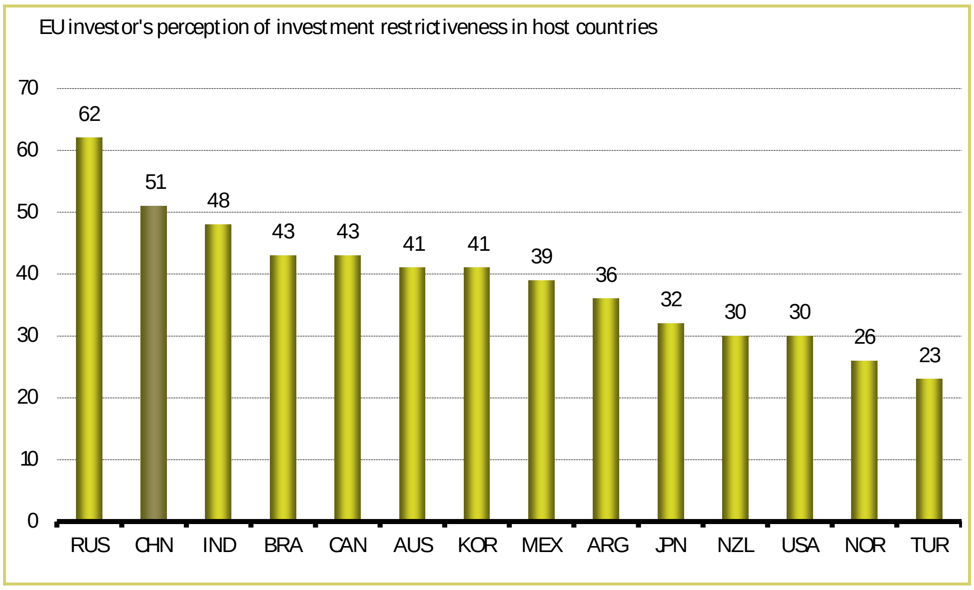
The survey index is therefore based on three large-scale surveys of more than 6.000 companies' perceived barriers to trade and investment in their main export and investment destinations relative to their home markets. The three surveys include 1.200 observation of perceived restrictiveness by 40 home countries (origin of the investment) in 146 host countries (location of investment) across 19 sectors.

The survey index reflects both EU and non-EU investors' perception of Chinese investment barriers as well as Chinese investors' perception of investment barriers in EU and non-EU countries. Although there continues to be many missing observations in the data set, the survey index is bilateral and is particularly useful in gravity model regressions where variations in FDI across both host and home countries are used to identify investment barriers.

Source: Copenhagen Economics(2012)

According to the Copenhagen Economics restrictiveness index, China is the second most restrictive country where Russia is the only country that is perceived to be more restrictive by EU investors, cf. Figure A.1.

Figure A.1 Investment barriers based on Copenhagen Economics survey index



Note: The index of restrictiveness ranges between 0 and 100, where 100 indicates that the country is completely closed to inward FDI and where 0 indicates that the country is completely open to inward FDI
Source: Copenhagen Economics survey of Chinese investment barriers

According to the same methodology the EU index stood at 27 and China 51.
The gravity model specification used explains the stock of bilateral FDI in 35 countries over the period 2000-2009 by means of a set of geographic and economic factors that impact FDI. The specification is based on recent research by Bergstrand and Egger (2011) who have developed the theoretical foundation for applying a gravity model on bilateral investments. In their specification, the stock of FDI depends on different sets of explanatory variables: gravity variables (including common border, language and distance), variables that describe the size of the market and the economic similarity of the two countries, variables that describe the relative endowments of capital and skills, a trade cost variable to account for tariff-jumping FDI, openness to outward FDI of the home country and a time trend (see box A.2 for more details on the econometric model).

BOX A.2: gravity model specification
The gravity model was run on aggregate FDI stock data from the OECD for the time period 2000 to 2009 based on bilateral FDI stocks between 15 non-EU countries (Argentina, Australia, Brazil, Canada, China, Iceland, Japan, Korea, Mexico, New Zealand, Norway, Russia, Turkey and the US) and 20 EU countries (Austria, Belgium, Czech Republic, Denmark, Finland, France, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Poland, Portugal, Slovak Republic, Spain, Sweden, the Netherlands and the United Kingdom). Since the focus is on external investment barriers intra-EU investments are excluded from the study. Data on FDI stocks is taken from the OECD statistics. Data on GDP, capital stocks and skills (secondary school enrolments) are from the World Development Indicators. The gravity model specification is based on recent research by Bergstrand and Egger (2011) who have developed the theoretical foundation for applying a gravity model on bilateral investments. In their specification, the stock of FDI (in logs) in country i from country j at time t will depend on different sets of explanatory variables:

- A set of time-invariant bilateral gravity factors including common border ($border_{ij}$), language ($language_{ij}$) and distance ($distance_{ij}$). Investments are expected to respond positively to common language and common borders but negatively to distance.
- A set of time-varying bilateral factors that describe the size of the market ($size_{ijt}=GDP_{it}+GDP_{jt}$) and the economic similarity of the two countries ($similarity_{ijt}=GDP_{it}/(GDP_{it}+GDP_{jt})$). Both of these variables are expected to stimulate investments between the two countries and the variables should enter positively.

- A set of time-varying bilateral factors that describe the relative endowments of capital ($capital_i/(capital_i+capital_j)$) and skills ($skills_i/(skills_i+skills_j)$). High levels of endowments are expected to attract more investments, and the two terms should enter positively. The specification includes fourth-order polynomials to allow for decreasing returns to scale.
- A time-varying bilateral trade cost variable ($tariff_{ijt}$) to take into account that investments may be driven by a tariff-jumping motive. If this is the case, investments from country *j* will respond positively to tariffs in country *i*. A time-invariant home country dummy to take into account the multilateral openness of the home country with regard to outward FDI (D_j).
- A time trend (*t*).
- Bilateral investment barrier perception index from the Copenhagen Economic's survey ($Survey_{ij}$)

Table A.1 presents the parameter estimates with OLS. All variables, except the bilateral tariff rates are significative and with the expected sign. The coefficient of the *survey* variable had then been used as a quantification of the incidence of investment barriers on FDI stocks.
Various robustness tests are performed to confirm the results (inlcuding Poisson maximum likelihood estimates), see Copenhagen Economics(2012).

TABLE A.1: Gravity model estimates

Variable	Expected sign	Survey index	t-value
Size	+	2.343***	[26.463]
Similarity	+	1.533***	[7.621]
Distance	-	-0.490***	[-5.011]
Border	+	0.405	[1.053]
Language	+	2.105***	[17.032]
Capital	+	0.189***	[5.419]
Skills	+	0.012	[0.667]
Tariff	+	-0.129	[-1.092]
Survey		-0.008***	[-2.666]
Observations		1,129	
R-squared		0.711	

Note: Time dummies, a constant and fourth-order polynomials have also been included in the regression but are not reported
Source: Copenhagen Economics (2012)

Using the gravity model estimates and framework, the four different scenarios described in section 6.1.3 have then been implemented.
In both the unilateral and the reciprocal liberalisation scenario, *China* moves closer to the level of restrictiveness facing foreign companies in the EU. China's index of perceived restrictiveness by EU companies is 51, whereas the EU index of perceived restrictiveness by non-EU companies is 27 according to the index derived from the surveys. The gap between the two indices reflects the scope of manoeuvring in the negotiations between the EU and China but the gap cannot be fully removed within the framework of a BIT between the EU and China. Many other factors (e.g. language, culture and central planning) explain the perception of a high level of restrictiveness in China. In the modest liberalisation scenario, three percent of the gap is closed, and in the ambitious scenario, 10 percent of the cap is closed.
In the reciprocal liberalisation scenario, the *EU* level of restrictiveness facing non-EU companies moves closer to the level of restrictiveness facing EU companies. The EU's index of perceived restrictiveness (internal restrictiveness) by EU companies is 15, whereas the EU index of perceived restrictiveness by non-EU companies is 27 according to the index derived

from the surveys. The gap between the two indices reflects the functioning of the Single Market and the gap cannot be fully removed within the framework of a BIT between the EU and China. In the modest liberalisation scenario, three percent of the gap is closed, and in the ambitious scenario, 10 percent of the cap is closed.

Using the results from the gravity model for the quantification of the incidence of investment restrictions and the investment liberalisation scenarios described above, the model points to an increase of the EU stock in China by 0,6 percent in the moderate scenario and by 1,9 percent in the ambitious scenario. In the reciprocal case, the Chinese FDI stock in the EU increases by 0,3 percent in the moderate scenario and by 0,9 percent in the ambitious scenario, as reported in table 6.1 of the main text.

2. CGE MODELLING OF THE MACRO ECONOMIC EFFECTS

The effects of improved access conditions for European MNEs in China are quantified in a general equilibrium framework. The analysis is based on a combination of the Copenhagen Economics index of perceived restrictiveness**Error! Reference source not found.**, combined with Eurostat data on the operations of European affiliates in China. The two pieces of information are integrated into a model-based assessment, where econometric analysis of trade and FDI barrier data is mapped into a computable general equilibrium (CGE) model of the world economy. The model is based on the final (unreleased) version of the GTAP8 database. In the econometrics and CGE model, trade and FDI are treated as complements.

Before modelling the impact of changes in the Chinese market access conditions that confront European MNEs, the first step is the benchmarking the impact of barriers on operating costs (specifying experiments for the CGE model based on these) so that these barrier can be implemented in the model. The starting point is the firm surveys, summarised in Table A2 below.

Table A2 FDI restriction indices (0=open, 100= closed)

Sector	EU	China	BRICs
Average	28.7	50.3	45.5
Manufacturing ISIC 15-35	31.0	46.8	44.7
Services ISIC 45,60-67,71t74	24.7	56.1	46.8

Note: See Copenhagen Economics (2012)
Source: Copenhagen Economics (2012) , firm survey data

The indices in the table reflect firm responses ranking the relative openness of different countries to MNE operations. Full market access (no restrictions) means an index value of 0, while a totally closed investment regime means an index rank of 100. From the range of firm responses, China's access conditions are more restrictive than the average for the BRIC countries. This reflects substantially greater restrictions in services than in the other BRIC countries. China is also ranked as far more restrictive than EU market access for extra-EU MNEs. It should also be noted that in the EU, firms operating on an intra-EU basis report even better access conditions than those in the table (which are for extra-EU transactions).

On the basis of the indexes in Table A2, the impact of MNE restrictions in China on the cost of operation of European MNEs is estimated econometrically, including both production activities within China, and the ability of European firms to sell goods and services from home through those same affiliates. These estimates are based on an econometric model where the impact of variations in these indexes is translated into estimates of increased cost of the combined operation of MNEs engaged in a mix of both importing (sale of home market activities) and local activities (operations of foreign affiliates). Both the cross-border and host

country set of inputs are affected by the restrictions in MNEs activities, therefore the cost terms are estimated though the trade impact of variations in the MNE restriction index.
For this, the following gravity equation is specified

$$\ln\left(v_{i,s,d}\right) = D_{i,s} + D_{i,d} - s_i \ln\left(t_{i,s,d}\right) + b_{d,i} \ln\left(Dist_{i,s,d}\right) + b_{M,i} \ln\left(Index_{i,s,d}\right) \quad (1)$$

Where the value of imports (v_i) between country s and d for each sector separately is regressed on importer and exporter fixed effects, tariff costs applied to imports value on an fob basis τ, distance and the index of bilateral NTB restrictions for MNEs generated from the survey data and ranging between 0=open and 100=closed. For the estimation, trade and tariff data for the year 2007 are used.[81] Overall the dataset includes roughly 350,000 observations covering trade in goods and services with bilateral trade and tariffs between 99 countries.

The sample includes also the zero-flows and the estimates are obtained with zero inflated Poisson (goods sectors) and Poisson (services sectors).[82] For the index, pairwise variations for intra-EU vs. extra-EU rankings of access to the EU market are used to estimate the underlying NTB elasticities. For all other pairs, as the dataset only includes a single index value, this is captured in the importer dummies. This use of estimated intra-EU NTB preference margins allows using a gravity model with importer and exporter dummies, as these bilateral preferences vary relative to average NTB rankings for each country. Otherwise, dummies preclude use of country-specific indexes in the regressions, as they would be perfectly collinear. Table A.3 summarizes the basic regression results. The tariff coefficient corresponds to s in the model outlined above (the substitution elasticity used for nesting trade and MNE activities). The NTB coefficients represent the estimated marginal impact of variations in the log of the MNE restriction index.

Table A.3 Regression summaries, 2007 cross-border sales and MNE restrictions

[Heading]	MNE restriction coefficient		Tariff coefficient		sample size
Wood, wood products	-0.3003	***	-7.239	***	obs: 5585
Paper, publishing	-0.9042	***	-12.314	***	obs: 5536
Metals	-1.0818	***	-8.379	***	obs: 6574
Machinery	-0.5336	***	-5.129	***	obs: 6012
Electrical machinery	-0.1179	***	-10.897	***	obs: 5976
Motor vehicles and parts	-0.2031	***	-8.778	***	obs: 5515
Construction	-0.5358	***			obs: 1419
Recreation and other services	-0.2086	***			obs: 1969
Transport	-0.4855	***			obs: 2971

[81] Trade in goods' data come from the COMTRADE database. These have been mapped to applied tariff data from CEPII's MacMAPs database and the WTO's tariff database. These tariff data cover actual, applied tariff rates given not only MFN commitments, but also regional and development policy-related preferential tariffs Services data are from Francois and Pindyuk (2010) based on a reconciled database that combines UN, Eurostat, and OECD services trade data.
[82] Poission is used rather than ZIP for services because we are uncertain about the validity of zeros in the data, and indeed have very few zeros at our level of aggregation once controlling for other right hand side variables.

Communication	-1.5769	***	obs: 2076
Financial and insurance services	-0.1742	***	obs: 2055
Business services nec	-0.3842	***	obs: 64*

*Note: goods regressions are based on a zero inflated Poisson (ZIP) model. services regressions are based on Poisson regressions. ***: significant at the .001 percent level. Note that for business services, we do not have evidence of lower NTB indexed between EU Members than for extra-EU sales. Therefore, we have simply run a Poisson regression of imports based on average NTB rankings, Population, GDP per capita, and economic distance*

Source: Copenhagen Economics (2012)

Since the term s is a price elasticity, this can be used together with the MNE restriction elasticity to estimate price impacts of variations in MNE restrictions index, the tariff equivalent using:

$$(2) \qquad \ln\left(g_{1i,s,d}\right) - \ln\left(g_{0i,s,d}\right) = \frac{b_{M,i}}{s_i}\left[\ln\left(Index_{1i,s,d}\right) - \ln\left(Index_{0i,s,d}\right)\right]$$

Table A.4 summarizes the estimated operating cost impacts (higher prices and costs) for EU MNEs operating in China derived from the FDI restriction index of table A.2. These are estimated cost reductions linked to a move from the current market access levels to those the EU itself provides to extra-EU firms. This move toward the EU level of access, comparable to what the EU itself provides to third countries, is treated as a benchmark upper-bound for plausible concessions and improved market access conditions that can be expected from China.

Table A.1 Estimated potential saving from moving China to EU market access levels

Sector	EU
Average	11.9
Manufacturing ISIC 15-35	7.3
Services ISIC 45,60-67,71t74	16.5

Note: Percent change

Source: Copenhagen Economics (2012) , Estimates from firm survey data and econometric model

It should be stressed that in this exercise the focus are the overall conditions of market access for MNEs. This is reflected in the summary measures used. Of course, how this is realized depends on what goes into the overall levels of access – the individual policies that map into general conditions affecting costs and the ability to operate in China. The data to estimate the cost impact of each individual policy are not available.

Once the cost equivalent of the MNE restriction variations are estimated, these can be used to model changes in market access for European MNEs in the CGE experiment under the different scenarios. The first scenario implies a very modest liberalisation (a three percent reduction in the estimated barriers reported in Table A.2 above). The second scenario implies a more ambitious reduction (based on a 10 percent reduction in the barriers summarised above).

The CGE model then used in this experiment is an extension of the traditional CGE framework because it also includes a representation of MNE activities. FDI are in fact modelled following an approach where MNEs sell a combined package of goods/services through a local affiliate that includes both local activities and imported goods/services from the European parent. Even where they sell goods directly (without further processing) local, affiliate activities linked to sale and distribution are still necessary. Technically, this means

MNEs are modelled as selling goods and services in China through a mix of local presence (the operation of foreign affiliates) and cross-border sales.
This approach captures the intensive margin (increased activities for European operations in China) and the effects linked to increased number of varieties available, but it does not capture impacts linked to entirely new goods and firms entering the market (the extensive margin). For this reason, the results reported should be viewed as conservative (a lower bound). Furthermore, since the modelling is done at industry level, the impact on individual European firms within particular sectors cannot be identified.
In the computational model, the “whole” economy, for the relevant aggregation of economic agents, is modelled simultaneously. This means that the entire economy is classified into production and consumption sectors. These sectors are then modelled collectively. Production sectors are explicitly linked together in value-added chains from primary goods, through higher stages of processing, to the final assembly of consumption goods for households and governments. These links span borders as well as industries. The link between sectors is both direct, such as the input of steel into the production of transport equipment, and also indirect, as with the link between chemicals and agriculture through the production of fertilizers and pesticides. Sectors are also linked through their competition for resources in primary factor markets (capital, labour, and land). The data structure of the model follows the GTAP database structure, and basic models of this class are implemented in either GEMPACK or GAMS (Hertel 1997, Hertel et al 1997). We work here with a GEMPACK implementation.

In more details the production of output is modelled as a function of a given technology, intermediate inputs, and value added services (capital, labour, land, etc.) taking into account the costs of intermediate inputs and services of capital, labour and land. A nested CES functional form is assumed83 to then map out the production side of the economy. For an open economy, given resources, technology (represented by technical coefficients in the CES functional forms), and prices for foreign and domestic goods and services, this part of the model can determine factor incomes, national income, and the structure of production. the system is then closed with a demand specification for a representative household. This involves allocation of regional income by the household to private consumption, public consumption and investment. Fixed expenditure shares are for each component of consumption (i.e. a Cobb-Douglas functional form), from which fixed savings rate derive. For personal consumption a CES utility function over goods is chosen. Accordingly, from the utility maximization, the price of utility from private consumption, the corresponding expenditure function and consumption quantities are then derived. Like private consumption, the public sector is also modelled with a CES demand function over public sector consumption. For investment demand, in the short run, a fixed savings rate is assumed. In the long-run, the model can alternatively incorporate a fixed savings rate, or a rate that adjusts to meet steady state conditions in a basic Ramsey structure with constant relative risk aversion (CRRA) preferences (Francois, McDonald and Nordstrom 1996, 1997).

Then, individual countries are linked through cross border trade and investment flows. With either monopolistic competition or Armington preferences, a CES composite good in terms of foreign and domestic goods is defined together with its price index and imports and exports are modelled.

[83] See Annex 4 of Copenhagen Economics (2012) for a full presentation of the equations in the CGE model.

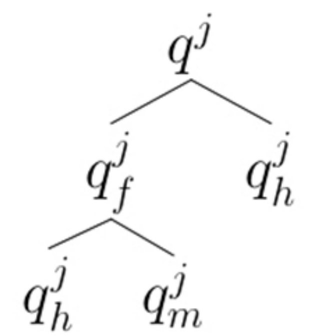
The basic system outlined above provides the core production and demand structure of each region, as well as the basic requirements for bilateral import demand, global market clearing for traded goods and services, and global capital account balancing. Within this basic structure, taxes, transport services, iceberg (deadweight) non-tariff barriers, and rent-generating non-tariff barriers are also introduced. These drive a wedge between the ex-factory price originating in country r and the landed prices in country h inclusive of duties and transport costs.

In a set of alternative labour market closures, supply of labour (both more skilled and less skilled) is specified as a function of the prevailing real wage rate, meaning that $l = a(w/P_c)^e$ where (w/P_c) is the wage deflated by consumer prices and e is the long run labour supply elasticity. From the DSGE literature, e=0.5 is assumed.

To extend the traditional CGE model and include the activity of MNEs, improved costs conditions for MNEs are modelled as applied to the delivered good or service supplied by the EU MNE. This is similar to the approaches followed in the FTAP model, the Michigan model, and the WorldScan model (see for example Lejour, Rojas-Romagosa and Verweij, 2008; Hanslow et al.,2000; and Brown and Stern, 2001).

To do this, the final supply to demand agents in each sector j in China is modelled as involving both domestic supply as well as supply from the foreign sector (e.g. European) that includes a mix of host country inputs (measured in units of the input bundles used to produce domestic supply) as well as imported inputs from the home country indexed. In other words, given that the GTAP database includes data only on the general cost structure of an industry in China (the total of domestic and foreign firms operating within China), the same local cost structure is used for both sets of firms.[84] Algebraically, the foreign affiliate sector is modelled with a CES aggregation function between host (local) and home (imported) inputs. This basic structure is illustrated below.

Figure A.1 Basic structure of the CES aggregation function



Source: Francois

In the figure above, goods or services in sector *j*, as delivered to final demand agents or downstream to other firms, involve a mix of home production indexed by *h* and production from the foreign (MNE) sector. The MNE sector itself uses a mix of local operations indexed by *h* and also source country operations indexed by *m*. All home country activities (whether taking place in local firms or in MNEs) are indexed by *h* as the same data from the source input-output data (GTAP) are used to represent costs.

[84] This reflects lack of data on detailed cost structures differentiated by national origin of firms.

The activities above are all modelled as CES functions, with common substitution elasticity s between host and home inputs. Functionally, this means a set of CES nests that capture the mix of home and foreign supply. The price of delivery for foreign goods depends on the price of both sets of inputs, as well as the impact of regulatory barriers, which are represent by the coefficient g in equation (3). This efficiency parameter is modelled as cost-raising (as opposed to a tax) meaning it represents increased cost of operations, and so also there are dead-weight costs linked to the volume of operations. The price is then

$$(3) \qquad p_{qf} = g\left[a_h^s P_h^{1-s} + a_m^s P_m^{1-s} \right]^{1/(1-s)}$$

In practice, the data requirements here are relatively minimal. Indeed, with manipulation of the CES nests involved, and scaling of the operating cost coefficient, it is possible to work with the data available to model a limited set of effects in relatively more detail, and to then map this to EUROSTAT FATS data (which are more aggregated) to provide additional estimates. The aggregation is needed because the survey data on MNE restrictions, as well as available trade data, have more sector detail than EUROSTAT FATS data on the operation of affiliates. In this way, the sector detail in some of the analysis (in the reduced form) is preserved when the impact of liberalizing MNE restrictions is modelled, while aggregating to available detail when EUROSTAT FATS level impacts are reported. The value for g is estimated econometrically, using index rankings of FDI restrictions in a gravity model of bilateral trade flows as discussed above.[85]

This framework is then used to model the different experiments under the different Options as discussed in chapter 5 and 6.

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[85] An advantage of this approach is that it makes minimal data requirements on an otherwise standard set of CGE modeling data. Where the terms g_m are held constant, MNE activities are simply subsumed (implicit) in the total domestic activities of a given sector, while we can then focus on changes in policy in those countries where we have data.

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ANNEX 4: Minutes of the 6th/final Impact Assessment Steering Group Meeting

EUROPEAN COMMISSION
Directorate-General for Trade

Directorate B – Services and investment, bilateral trade relations
Unit B2 - Investment

Brussels, 25.05.2012

Meeting Report

6th Meeting of the Impact Assessment Steering Group on a future EU-China investment agreement 22 May 2012

Participants: see attendance list below

1) Overview of state of play of the Impact Assessment

DG Trade (Weinzierl) presented the **state of play on the impact assessment** (IA) on an EU-China investment relationship. She summarised the remaining timeline for the impact assessment (IA) and asked for written comments to be submitted by 24 May. She noted that the circulated draft did not differ from previous versions in its structure, but was more focused on analysing policy options 2 and 3 and ignored politically unfeasible options. The circulated draft moreover provided sectoral breakdowns for the economic, labour and environmental impacts by sector. She expanded that the initial plan to attach a detailed annexe on the impact of an agreement on states' right to regulate had been abandoned as the main report was sufficiently detailed. Concluding, she noted that DG Trade should soon receive the final version of the external study, which should then be attached to the IA.

2) Comments and General Discussion

DG Employment (Ruda) thanked DG Trade for taking previous comments on board and agreed that the Annex had become superfluous since the questions on the right to regulate where satisfactorily dealt with in the main report. She voiced two follow-up comments. First, she suggested adding a reference to e.g. OECD codes and guidelines on Corporate Social Responsibility (CSR) to the parts on labour standards or states' right to regulate. She expanded that the negotiation guidelines should contain a reference to CSR. Second, she noted that the list of monitoring indicators did not include any indicators so as to monitor states' right to regulate or the non-lowering of standards clauses. She suggested including adequate indicators into the list and proposed a number of potential indicators (business surveys, etc.).

DG Trade (Weinzierl) thanked DG Employment for the comments and suggestions. She clarified that DG Trade sought to promote CSR and would add a reference to the IA and the intention to pursue this in a Commission proposal for future negotiation guidelines. On the second comment, she noted that extending the list of indicators was indeed useful. DG Trade would reflect on possible indicators.

EEAS (King) voiced several comments regarding the role of Human Rights in the IA. He thanked DG Trade for including into the section on the EU's general objectives (section 4.1) a reference to the EU's overall objectives of external action (Art.21 TEU), which comprised the promotion and protection of Human Rights. He however commented that these overall objectives, however, were not directly reflected in the list of the EU's operational objectives (section 4.3). Equally as regards Policy Option 2 on a standalone investment protection agreement in section 5.2, he suggested adding a reference to clauses, which ensured that an investment agreement had no inadvertent effect on the protection of Human Rights in the EU and China.
Another comments, related to section 6.3.2 on the impact of an investment agreement on labour conditions which mentioned the problem of forced labour in Chinese prisons. He suggested to clarify the reference since it currently implied that forced labour in prisons was legal and specified that there were two types of camps in China – prison camps and education camps – where people were forced to work. Education camps were primarily producing for export. He added that 6.1 million people were imprisoned in prison camps and an unknown number in education camps.
He voiced regret that section 6.5 on the impact of an investment agreement on Human Rights did not in his views sufficiently reflect the EEAS' concern that obligations contained in an investment agreement might undermine international Human Rights obligations of the contracting parties. Even if DG Trade did not agree with the EEAS' position, it should mention the concern in its IA. He expanded that he did not understand the distinction between direct and indirect impact of an agreement on Human Rights. His key concern was that without an explicit reference to Human Rights in an agreement, arbitrators would not be obliged to take Human Rights into account. He highlighted that the 3rd paragraph of section 6.6 suggested that arbitrators had to evaluate the proportionality of a measure, but he wondered whether this obligation also applied to cases involving China as it had not ratified several conventions in this domain. He concluded that section 6.6 contained a reference to a study on ISDS of 2006 which was not up to date and wondered whether more recent figures were available.

DG Trade (Weinzierl) thanked the EEAS for its comments. She replied regarding the EEAS' suggestion on integrating the EU's general external action objectives into the operational objectives there had to be a distinction between the overall context and the main objectives of an investment agreement. Furthermore the objectives now stressed the need for states to retain the right to pursue legitimate public policy objectives which included human rights.
Regarding the second concern on an inherent conflict between investor rights and Human Rights, DG Trade disagreed with the EEAS' view. In DG Trade's opinion there was no inherent conflict between both sets of rights. States had the possibility to advance Human Rights obligations as defence against investor claims. Arbitration tribunals had then to examine whether Human Rights obligations were a valid defence for the state measures in question. DG Trade considered that the Vienna Convention assured that arbitrators had to take all international obligations of states – including Human Rights commitments – into account. She also pointed out that investment law protected the right to property and the right to fair compensation in case of expropriation, which was indeed a fundamental and Human Right. She invited the EEAS to further clarify why and where it saw an inherent conflict between investment law and Human Rights. She drew attention to the ongoing interservice consultations on investor to state dispute settlement proceedings (ISDS), where the EU's

general approach to ISDS were also being discussed. In this context, DG Trade had proposed to include a reference to the Vienna Convention in an article on rules of interpretation.
Finally this discussion had already been subject to an exchange of notes of a general nature between the EEAS and DG Trade and it would be best to pursue any further discussion in that framework.
Furthermore, she thanked EEAS for its clarification on different types of labour camps, which would be considered. Regarding the EEAS' comments on the data for numbers of dispute cases and on ISDS developments cited in the IA, she agreed that it was preferable to also analyse the most recent cases and ISDS developments but that it was difficult to obtain reliable new data. The summary of cases and judgements could only be an approximation.

EEAS (King) replied that it was happy with the just stated position of DG Trade. This position was, however, not clearly reflected in the draft text of the IA. States should be allowed to pursue Human Rights policies and arbitrators should be obliged to take these policies and obligations into account when examining and judging a case.

DG Trade (Weinzierl) stressed that the defendant state could raise any point so as to defend its measures in ISDS proceedings. Hence, a defendant state could always raise its Human Right policy and international obligations as defence against an investor claim. She enquired, whether the EEAS would be satisfied, if operational objective no. 9 included a list explicitly specifying that public policy objectives included the protection of Human Rights.

DG Enterprise (Avezou) stressed that section 6.1.3.3 should be more specific in evaluating the challenges and the impact of an agreement on SMEs. He suggested incorporating findings from the Commission study "*Small business, big world*" (2011) into the IA. He further expanded that a recent Commission communication had laid out the EU's objective to better accompany European SMEs in going abroad. He proposed to mention that the conclusion of an investment agreement also advanced one of the communication's objectives. He continued that the reference in footnote 7 should be clarified. Finally, he pointed out that the IA also referred to Chinese SMEs, which, however, were different in size and structure, as Chinese and EU statistical indicators differed.

DG Trade (Weinzierl) thanked for DG Enterprise's comments. She reported that DG Trade had undertaken a fieldtrip and organised specific seminars in Beijing so as to better understand the situation of EU SMEs in China. She stressed, however, that EU SMEs hardly invested in China, which complicated the analysis of the impact of an agreement on SMEs. But a reference to the study would be welcome and could be integrated.

DG Enterprise (Avezou) drew attention to the operational objective of an agreement to increase the competitiveness of EU companies in China (p.17) and suggested to explicitly mention SMEs in this context. He agreed with TRADE's analysis that EU SMEs hardly invested in China.

DG Trade (Weinzierl) replied that it was difficult to define a SME-specific operational objective, as the subsequent analysis in the IA had to be consistent and refer back to these objectives. She reassured DG Enterprise, however, that DG Trade wanted to make sure that SMEs would benefit from an investment agreement with China.

DG Justice (Depaigne) returned to the relation between an investment agreement and Human Rights. DG Justice considered previously voiced concerns as a procedural issue and stressed that he did not see a substantive problem regarding human rights. It highlighted that if provisions in an investment agreement were not sufficiently clear, it might be more difficult in arbitration proceedings to advance certain state obligations and rights as defence. A recent case between Argentina and Siemens had demonstrated that tribunals could decide not to examine states' fundamental and Human Rights obligations. In its view, previously observed misunderstanding and disagreement on the relationship between investor rights, fundamental and Human Rights derived from this procedural concern. He suggested to explicitly spell-out the implicit argument of the IA that states should have the right to advance fundamental and Human Rights as defence in arbitration proceedings and that tribunals had to pay attention to this defence. He thought that the mere statement that states had the right to pursue legitimate public policy objectives in the agreement and IA was insufficient. He proposed integrating references to fundamental and Human Rights and mentioned procedural issues on pages 40 and 41.

DG Trade (Koutoglidou) replied that there might be a gap in communication. She elaborated that one had to distinguish between Human Rights and Human Rights law. Human Rights law was set in international treaties, like UN Charters or the Charter of Fundamental Rights of the European Union. MS and EU were bound by these Human Rights obligations. However, China was not bound by the same treaties, which provided for a differentiated impact of Human Right references in an investment agreement on China, the EU and MS. DG Trade intended to make clear that EU and MS were bound by their Human Rights commitments and that an investment tribunal needed to take these obligations into account when examining a case. The treaty would thus contain explicit references to the rules of interpretation of the Vienna Convention and standards of public international and administrative law.

Turning to arbitration case between Argentina and Siemens, **DG Trade (Koutoglidou)** pointed out that the example was misleading. She explained that Siemens had waved its right to compensation. Investigations had shown that the contract under examination had been awarded to Siemens due to bribery. So Siemens was not entitled to receive an award and there was no need to examine Human Rights issues. Regarding Argentina, there were many other often discussed arbitration proceedings supposedly touching upon Human Rights. Some observers had argued that Argentina had expropriated investors in public utilities, because such investors had for instance undermined the Human Right to water. She expanded that – to her knowledge – none of these cases contained any references to Human Rights. Any remedies awarded, such as in the water case, had been justified on legal grounds which were not related to Human Rights. She concluded that the IA should not address general issues of interpretation of investment agreements. It was, moreover, clear that Human Rights law was – in term of norms hierarchy – superior to international investment law.

DG Justice (Depaigne) replied that it was mainly concerned, because the tribunal had not even looked into Argentina's Human Rights obligations.

EEAS (King) stressed that DG Justice had put its finger on the crux of the matter. The EU had to make sure that tribunals had to examine states' Human Rights obligations. EU MS investment agreement could afford to be unspecific on this issue as their external policies were not under the legal obligation to promote and protect Human Rights. The EU, however, was legally bound to do so under Art. 21 TEU. It was true that the IA might not be the appropriate place to settle the issue. Nevertheless, the problem should be noted in the text.

DG Trade (Weinzierl) replied that the defendant state was free to advance its Human Rights obligation as defence.

DG Trade (Koutoglidou) elaborated that ISDS proceedings were not the appropriate place for the interpretation of Human Rights law. Tribunals, like the International Court of Justice, were in charge of this matter. She continued that investment tribunals had to take into account domestic law of the defendant state.

EEAS (King) replied that tribunals should take into account all international obligations of the defendant state, but were nevertheless free to ignore Human Rights obligations.

DG Trade (Weinzierl) reiterated the defendant state could advance Human Rights obligations as a defence, which then had to be examined by the investment tribunal. She added that the agreement was going to include provisions highlighting states' right to pursue public policy objectives which was also reflected in the operational objectives of the IA. She concluded that there would be other occasions to discuss the matter in more detail and took note of a degree of dissent over the general functioning of investor to state dispute settlement mechanisms which would be followed up on in the substantive discussions on such standards and were particularly relevant to the inter-service consultation on ISDS provisions.

Eurostat (De La Fuerte) advanced four comments. First, he asked DG Trade to double-check the figures and their sources in section 3.1 and 3.2. Eurostat thought that these figures were extracts of Eurostat data and should be labelled as such. Second, in section 3.1 a blue box next to the text indicated that the IA built on Eurostat and Chinese statistical data. The text directly below referred, however, to World Bank data. This should be corrected. Third, on page 21 it was stated that there was an annexe on the methodology used in the Copenhagen Economics study. However, there was no such annexe. Finally, the IA listed only Eurostat's FATs data base as source. However, it would be more appropriate to quote it as Eurostat Online Data Base adding the website, because the IA does not only build on FATs data.

DG Trade (Weinzierl) thanked Eurostat for its comments. She stressed that not all indications in the IA were yet up-to-date, but would be checked before final submission. Regarding the annexe, she explained that an annex would be attached to the final IA.

DG Trade (Sousa) clarified that the final draft would contain a summary of the methodology used in Copenhagen Economic study so as to facilitate understanding for non-economists. DG Trade could, however, provide a detailed overview of the used methodology, if Eurostat asked for it.

Eurostat (De La Fuerte) thanked DG Trade and clarified that a good understanding of the methodology was key so as to evaluate the correctness of the findings of Copenhagen Economics and conclusions in IA.

DG Internal Market and Services (Bodiaux) commented that page 42 conveyed that there were 102 publically known ISDS awards. The examined period of time, however, was unclear. This should be clarified.

3) Conclusion and next steps

DG Trade (Weinzierl) recalled that **written comments and question were welcome by 23 May 2012.**

Robert Basedow/Pauline Weinzierl

Impact assessment steering group – EU-China Investment relations
List of Members, attendance 6th meeting, 22 May 2012

Name	DG	Unit & Responsibility	Attendance 16/01/2010	Attendance 12 April 2011	Attendance 19 July 2011	Attendance 7 February 2012	Attendance 18 April 2012	Attendance 22 May 2012
1. RUBINACCI Leopoldo	TRADE	B2 Head of Unit	(Ignacio Iruarrizaga Yes)	No	Yes	No	No	No
2. WEINZIERL, Pauline	TRADE	B2 – China overall coordination for investment issues	**Yes**	Yes	Yes	Yes	Yes	Yes
3. BLANK Selma	TRADE	B2 - Investment	Yes	Yes	No	No	No	No
4. ARTO Clemence(replaced by Robert Basedow)	TRADE	B2 – Trainee	No	Yes	Yes	Yes	Yes	Yes
5. WEGRZYN Radoslaw	TRADE	C1 – China bilateral relations	Replaced by Filip Deraedt Yes	Yes	Yes	yes	Yes	Yes
6. MIGLIOLI Chiara	TRADE	G1 – Market Access China	Yes	No	No	No	No	No
7. PIOVESANA Regina	TRADE	G2 – Industrial sectors China	Yes	No	No	no	No	No
8. SALLARD Delphine	TRADE	01 – Head of Unit - Audit and Impact Assessment	Yes	No	Yes	yes	Yes	No
9. JAMES Richard	TRADE	01 Internal Audit	Yes	No	No	no	Yes	No
10. POIRIER Virginie	TRADE	01 Internal Audit			Yes	yes	Yes	Yes
11. CERNAT Lucian	TRADE	G2 – Head of Unit – Chief Economist	Yes	No	No	no	No	No
12. Kay Parplies (Now: Nuno Sousa	TRADE	G2 – China – Chief Economist	Yes	Yes	Yes	Yes (replaced by Nuno Sousa)	Yes	Yes
13. FORMENTINI Silvia	TRADE	D1 – Sustainable	Yes	no	No	no	No	No

		Development and CSR – China						
14. Herrmann Martin	TRADE	01 Audit stagiare				yes	No	No
15. CURTIS Michael	SG	F3, External institutional relations	Replaced by MORAN Mary-Teresa	No	Yes	yes	No	Yes (replaced by Simona Benedetti)
16. SIEBERN-THOMAS Frank	EMPL	F1 – Social Dialogue	Yes	No	No	no	No	No
17. Daniel WATERSCHOOT	EMPL	A4 - External Relations, Neighbourhood Policy, Enlargmenet, IPA	No	Yes	No	no	No	No
18. Magdalena RUDA	EMPL	A4 - External Relations, Neighbourhood Policy, Enlargmenet, IPA	No	Yes	No	yes	Yes	Yes
19. MARIN Antongiulio	CLIMA	A2	No	Yes	No	no	No	No
20. HEUZE Thibault	MARKT	International Relations - China	Yes	No	No	yes	Yes	No
21. OSSMANN Klaus	MARKT	Capital movement	Yes	Yes	No	Yes (replaced by BODIAUX Marketa)	No	No
22. TOFT Torben	COMP	A1, International Relations China	Yes	Yes	(replaced by Fransesco Massignani)	Yes (replaced by Maria Larionovi)	Yes	Yes
23. Marianne COTIS	COMP	A5 – International Relations	No	Yes	No	no	No	No
24. VONTHRON Jacques	BUDG	A4, Head of Unit	No	No	No	no	No	No
25. MAGNUSSEN Lars Jorgen	BUDG	A4, Budget rapporteur of DG BUDG for	No	No	No	no	No	No

			external policies expenditure						
26.	CATIZZONE Mario	RTD	International Cooperation - D1: China	Yes	Yes	No	yes	No	No
27.	AVEZOU Jean-Marie	ENTR	A2 – Policy Officer - China and conclusion of the EU-Korea FTA	Yes	Yes	No	yes	No	Yes
28.	PAPE Wolfgang	ENTR	A2 International affairs	Yes	No	No	no	No	No
29.	JOCHHEIM Ulrich	ECFIN	D3 Economic Analyst - Desk officer for China, IMF issues and external representation of EMU	No	No	No	no	No	No
30.	RONCO ZAPATERO Juan	MARE	B-4 "Markets and Trade	No	No	Yes	yes	Yes	Yes
31.	MEGGIOLARO Francesco	EEAS	China (Trade issues)	Yes	No	No	yes	Yes	Yes
32.	Liliana STRUGARIU	EEAS	H2	No	Yes	No	No	No	No
33.	RIOS OLMEDO Ana	MOVE		No	No	No	no	No	No
34.	DE MEYER Luc	TAXUD	B4 – China desk	No	Yes	No	no	No	No
35.	Ailsa BROWN	TAXUD	B4 - International coordination - Americas, Africa, Far East & South Asia - multilateral organisations	No	Yes	No	no	No	No
36.	DE LA FUENTE LAYOS Luis	ESTAT		No	Yes	Yes	no	No	Yes
37.	SOMBSTHAY Alexandra	ENER		No	Replaced by Margaret	No	no	No	No

					a DJORDJ EVIC				
38.	FAUCONNO T Maud	ECFIN	D3	No	No	Yes	no	Np	No
39.	STRUS Joze	JUST	C1	No	No	Yes	no	No	No
40.	DEPAIGNE Vincent	JUST	C1	No	NO	Yes	yes	No	Yes
41.	KULICK Andreas	LS		No	No	No	No	Yes	No
42.	BERGMUEL LER Florian	SG	F3	No	No	No	No	Yes	No
43.	KING Toby	EEAS	Human Rights Division	No	No	No	No	Yes	Yes
44.	THIVOLLE Jean-Claude	RTD	D1	No	No	No	No	Yes	No
45.	DERAEDT Filip	TRADE	C1	No	No	No	No	Yes	No
1.	LAZZERINI Irini	ENVI	China	Yes	Yes	No	no	No	No
2. 3.	CIELESZYN SKI Bartosz	ENV	E1	No	No	No	No	Yes	No
4.	Malgortzata JANKOWSK A	EEAS	Asia Divisions	No	No	No	No	Yes	No
5.	BENDZ Johan	BUDG	A4	No	No	No	No	Yes	Yes
6.	BODIAUX Marketa	MARK T	F1	No	No	No	No	No	Yes
7.	Koutoglidou Alexandra	TRADE	B2	No	No	No	No	No	Yes

<u>ANNEX 5: Summary of contributions to the European Commission's public consultation on "The future investment relationship between the EU and China"</u>

DIRECTORATE GENERAL FOR TRADE
EUROPEAN COMMISSION

Summary of contributions to the European Commission's public consultation on "The future investment relationship between the EU and China"

Disclaimer:
This document does not present the official position of DG Trade or of the European Commission. It is designed to summarise the views of interested parties who gave comments on the future investment relationship between the EU and China. The suggestions in this document in no way prejudge either the nature or the form or content of any future action by the European Commission

1. INTRODUCTION

In the context of an Executive-to-Executive meeting on 29 April 2010, European Commission President Manuel Barroso and Chinese Premier Wen Jiabao instructed their respective teams to study the options for enhancing the bilateral investment relationship between the EU and China. To this end, a "Joint EU-China Investment Task Force" was launched in summer of 2010 to explore the scope for deeper cooperation on investment, including considerations of a possible standalone investment agreement.

In this context, the European Commission launched a broad public consultation to gather views from relevant stakeholders regarding the future EU-China investment relationship.

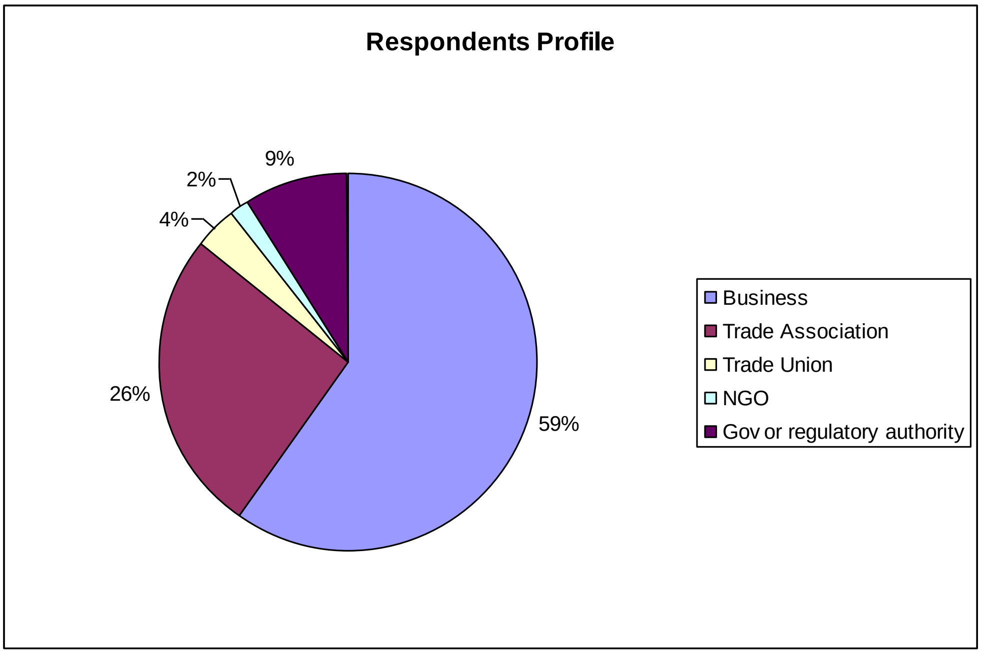
The replies to the questionnaire provide the European Commission with data, information and views of stakeholders about the current barriers and protection standards affecting EU direct investment in China, and about the (possible) effects of an EU investment agreement in China.

2. THE PUBLIC CONSULTATION AND THE QUESTIONNAIRE

The public consultation ran from 5 May to 5 July 2011. The exercise was open to all stakeholders, both within the EU and in third countries.

An on-line questionnaire, hosted by the European Union's Your Voice in Europe's web site, was open to all stakeholders interested. The questionnaire had 34 questions covering three main topics: investment environment in China, investment environment in the EU, and the potential impacts of an EU-China investment agreement. The written version of the on-line consultation is to be found at:
http://trade.ec.europa.eu/consultations/?consul_id=153

In all, 57 exploitable answers were received from a wide range of respondents. Submissions came from private companies having their headquarters in 16 different Member States, trade associations, trade union, governmental authorities and NGOs.



59% of the respondents were companies, 26% were trade associations. The business sectors represented were diverse, both in services and non-services, including among others the steel industry, distribution services, manufacturing, mining, automotive, banking and other financial services, pharmaceuticals and legal services. 75% of the respondent companies had already invested in China, mostly in the form of Greenfield investment (for 2/3 of them) and under a wholly foreign-owned status (for 70% of them).

In addition, 9% of the replies came from governmental or regulatory authorities, 4% from trade unions and one of the respondents was an NGO.

The full list of contributors is attached in the annex and links to those contributions where respondents agreed to have them published will be made available on the Trade website.The on-line consultation exercise made clear that all contributions would be published unless respondents indicated that they did not wish their contribution to be made public.

3. EXECUTIVE SUMMARY AND CONCLUSION

On the general **evolution of the investment climate in China** in the past 5 years, the views were quite balanced between those who believe that the climate has improved (36%) and those who believe that it has worsened (24%). The general perception was that China had modernized its investment and business environment as a result of its accession to the WTO and a general economic reform process. However this evolution seems to be uneven across sectors and many obstacles and difficulties remain for foreign investors. Some respondents even raised a "reform fatigue" phenomenon and recently increasing protectionism.

China seems to be an **increasingly strategic market for EU investors**, with 60% of business respondents foreseeing China as a Top 5 destination for investment in their sector in 10 years time compared to 46% in 2011. In addition, 11 business respondents predict for China to become a more important destination for investment in their sector in 10 years time than it is now. The five **most attractive aspects of the Chinese market** are the size of the Chinese market, the proximity to the clients/market, the lower labour costs, the costs of resources and the productivity.

Regarding the **barriers to investment in China**, most of the respondents indicate that they have experienced difficulties when investing, or trying to invest in China, some of them even stating that those difficulties deterred them from going through with investment plans. Most often, the barriers encountered arose both before investing (i.e. pre-establishment) and after having invested (i.e. post-establishment). The most problematic barriers identified by the respondents were: licensing requirements/procedures, foreign ownership limitations, regulatory approval procedures, prohibition to invest/limited scope of business, joint venture requirements, subsidies enjoyed by Chinese companies and technology transfer requirements. Half of the respondents also experienced a form of **unfair treatment** and several of them claim to have experienced issues linked to the protection of their **key technologies** when investing in China.

The public consultation also showed that the main **problem respondents saw in China related to barriers to the market** and the **lack of a level playing field** once they had managed to invest in China. On balance the added value therefore was felt to be in an agreement which would help create better access to the market and crucially **increase transparency, legal certainty** and fair treatment of foreign investors. It was also clear that instruments afforded by investment protection agreements, in particular investor to state dispute settlement, were considered as less crucial since resorting to investment arbitration against China was felt to be a last resort only given the fear of retaliation by China.

The **merger review procedures** are equally an area of concern for EU investors in China, with only 12% of respondents considering that those procedures are followed in a fair, reasonable, predictable and non-discriminatory way.

A substantial number of respondents consider that **China's subsidies policy** acts as a barrier to investment in China, stating that those subsidies which are not attributed in a transparent manner largely favour Chinese companies and that this distorts competition and creates an unlevel playing field between foreign and domestic companies in China.

On the **Chinese legal system**, 80% of the respondents said that they did not have confidence in it to protect their rights as investors because of the lack of transparency and consistency of the system which is subject to political pressure. They rely mostly on amicable settlement to deal with legal conflicts in China, and most of them indicated that they would consider starting **investment arbitration** proceedings against China only in case of complete expropriation, because of the fear that it would deteriorate their relationship with the Chinese Government.

Regarding the **investment climate in the EU**, a strong majority of respondents believe Chinese outward investment in the EU is increasing. However, when asked specifically about the investment in the EU by **Chinese state-owned enterprises (SOEs),** a majority of them replied that they see no particular issues. About 1/3 of them however indicated that they have concerns about the unfair competition created by the differences in the situation of EU companies and Chinese SOEs, notably because of the subsidies received by the latter, which do not face the same strict competition/state aid rules as companies in the EU.

The replies to the question regarding the **impact on the investment climate** of an EU-China investment agreement show strong support to an initiative which would aim to facilitate EU investment in China. Most of the respondents express a strong interest in obtaining better access to the Chinese market and in the elimination of unfair competition with domestic companies. They also emphasize the need to improve the legal framework for EU investors in China by ensuring more clarity and predictability, as well as a better implementation of the rules.

A majority of respondents considers that EU-China investment cooperation should focus specifically on facilitating EU **Small and Medium Enterprises'** investment in China. In general, the barriers encountered by SMEs in China are the same as the ones encountered by large companies, but those barriers are more pronounced for SMEs, which do not always have the financial and human resources needed to bear long and expensive administrative or legal procedures. They emphasized the need for simplified rules, better information and specific assistance for SMEs investing in China.

A large majority of respondents believes that it would be preferable to have **one single EU agreement covering investment protection** rather than 25 different Bilateral Investments Treaties (as at present) with China. An EU-China agreement would contribute to clarifying the legal and operational framework for EU investors in China, and reciprocally, thus increase efficiency and business confidence. Several respondents however stressed the need to ensure that the_level of protection is at least equivalent to the "best" BIT concluded by Member States and that such a new agreement would not negatively affect existing rights of investors provided in existing BITs. In addition to the standard investment protection provisions, several respondents pointed out that such an agreement would also need to focus on implementation and enforcement of commitments (including existing WTO commitments).

Regarding the potential **impact of an EU-China investment agreement on employment and labour standards,** the majority of the respondents believes that they could be positively affected by such an agreement, both in the EU and in China. The potential positive impacts mentioned relate mostly to the creation of employment opportunities, especially more qualified jobs and to the best practices exported by EU companies to China in terms of e.g. labour standards, safety and corporate governance. Some respondents however expressed concern that an EU-China investment agreement could create unfair competition due to the difference in the cost of labour, thus encouraging a lowering of social standards and a relocation of EU enterprises to China. Some respondents advocated the inclusion of a set of core labour and social standards in such an agreement, to which both parties would commit. At the same time other respondents (trade associations, in particular) stressed that social and labour issues fall outside the scope of an investment agreement and should not be covered by it.

Concerning the potential **impact of an EU-China investment agreement on the environment**, a majority of respondents believes that this agreement could have a positive effect in China and a positive or neutral effect in the EU. They highlighted the improved opportunities that this agreement could bring for better cooperation and integration by both EU and China on sustainable development objectives. They also thought that it could positively influence China's environmental policies by increasing policy transparency and encouraging the implementation of mutual standards. Some of the respondents however feared that if no global standards were set, such an agreement could encourage countries to lower environmental standards and policies in order to attract investment. As in the context of employment and labour standards, a number of respondents, while stressing the need to ensure equal treatment of domestic and foreign companies in the implementation of environmental regulation, advocated against the integration of environmental standards and mandatory requirements in such an investment agreement, since such issues should be addressed elsewhere.

Finally, asked about the potential **impact on human rights**, a majority of respondents replied that an EU-China investment agreement would have no impact in the EU. In addition, almost half of the respondents thought that an agreement could have a positive impact on China. They pointed out the opportunity for better cooperation and exchange of information, which could increase transparency and positively influence Chinese human rights policies. Contrary to these opinions, some respondents expressed concerns that such an agreement could encourage a lowering of EU practices and standards. In general they believe that the impact could be positive, provided that the agreement included specific provisions on human rights standards, whereas other believe that those standards should not be included in such an investment agreement because it could paralyse negotiations and potentially threaten or weaken the protection of EU investment abroad.

4. RESPONSES TO THE QUESTIONNAIRE

I) INVESTMENT ENVIRONMENT IN CHINA

In the online questionnaire, several questions in this part were shown only to respondents having indicated before that they were either a business or a trade association representing businesses. With a view to present the results more clearly, the order of the replies reproduced below does not match exactly the order of the online questionnaire.

A) Questions for companies and trade associations having already invested in China:

1. *Question: On a global basis, where do you rank China as a destination for investment for your sector? a) in 2011 and b) in 10 years*

In 2011, 16% of the business respondents (companies and trade associations) rank China as top destination for investment in their sector, 46% rank China as top 5 destination, 27% as top 10 destination and 11% indicate that China is not a top 10 destination for investment in their sector. Concerning future investment plans, China appears to be an increasingly strategic market for the business respondents. Indeed, 60% of them predict China to be a top 5 destination for investment in their sector in 10 years compared to 46% in 2011. Moreover, 25% of business and trade association respondents predict China to become a more important destination for investment in their sector in 10 years time than it is now.

2. *Question: What is the status of your operation in China?*
3. *Question: What kind of investment have you made in China?*

4. Question: *When did you start investing in China?*

75% of the respondent companies had already invested in China, and most of them started investing in China a long time ago: 42% started investing over 10 years ago and 50% between 2 and 10 years ago. The results obtained with this public consultation thus come for a large part from companies that have both a long term view for their investments in China, and a good knowledge/experience of the Chinese market and policies. 2/3 of investments were realised as Greenfield investments and 1/3 as mergers & acquisitions. Finally, 70% of the investments made by the respondents were constituted as wholly foreign-owned enterprises (WFOE), 25% as joint ventures (JV) with the EU investor holding a majority share and 5% as a JV with the EU investor holding a minority share. The domination of WFOE in the respondent companies is also interesting because it can give us a view on the specific difficulties encountered by these kinds of companies in China.

5. Question: *Which aspects and factors of the Chinese market attracted (or attract) you the most and made (or might make) you decide to invest?*

Out of the 15 elements and factors that were listed as possible replies to this question (in addition to the possibility of indicating extra factors), **five of them appear as the key factors: the size of the Chinese market, the proximity to the clients/market, the lower labour costs, the costs of resources and the productivity.** Others factors mentioned: the good infrastructure, the proximity to talent, the ease of doing business, research and development, the attitude of authorities and the attitude of local partners.

6. Question: *Have you experienced difficulties when investing, or trying to invest, into China?*

   If you answered yes, did these difficulties arise mostly:

   - *Before investing in China (i.e. pre-establishment)?*
   - *After having invested in China (i.e. post-establishment)?*

29 respondents indicated that they (or their members) have experienced difficulties when investing, or trying to invest, into China. Most of the respondents who experienced barriers indicate that they arose both pre-establishment and post-establishment.

Some of the respondents were completely prevented from investing in some sectors which are entirely closed to foreign investors. In particular, the *European Express Association*, a trade association representing the interests of the express integrators, mentioned the revised "Catalogue of Industries Guiding Foreign Investment", which added domestic express delivery to the prohibited list of sectors. A large company also mentioned the increased restriction for investment in *high and new technologies* such as the development of *genetically modified and bio agriculture*.

A large number of respondents stressed the foreign ownership limitations and/or the joint venture (JV) requirements that they faced when investing in China. For instance, based on China's steel industry policy issued in 2005, foreign investors in the *steel sector* cannot have a majority shareholding as the steel industry is considered a "strategic" industry related to "national security". One of the companies operating in the steel sector explained that the JV requirements they faced made them restrict their investment plans to areas open to wholly foreign-owned enterprises. Another company in the steel sector explained that they established a JV in 2002, but due to different cultures and lack of operational control they had to dissolve it after 4-5 years. They also complained about the limitations of access to strategic raw materials. Several companies from the *automotive sector* mentioned the new draft Catalogue, which limits foreign investment in "key new energy vehicle component manufacturing" to joint ventures with no more than 50% ownership by the foreign partner. Finally, a company operating in the *power and rail transport sector* raised the issue of the prohibition to hold majority share in power generation and rail and the excessive and unpredictable control of foreign investments according to the national security review mechanism.

The length of the licensing and regulatory approval procedures was another barrier to investment often mentioned by respondents. One of the companies even stated that it had to create an administrative department for the sole purpose of dealing with the ongoing government requirements.

Moreover, many respondents complained about the lack of regulatory transparency and predictability. They mention opaque regulations, often only published in Chinese, different standards and inconsistent implementation of laws at national, provincial and local level, as well as continuous modification of regulations with immediate effect. One of the examples given was the sudden change in the recently published *social insurance law* leading to a substantial increase in the company contribution to employees' insurance cost. A *packaging material and machinery* company also stated that it lost 1 million € because of discordance among different institutions about machinery duty free import.

Among the difficulties experienced by the respondents when investing in China, the infringements of intellectual property rights and poor enforcement of the existing legislation protecting intellectual property appear quite frequent. According to a trade association, the legislation exists but the application and enforcement is difficult and becomes expensive, therefore patents are often not registered, increasing the risk of being copied. According to a company from the *steel industry*, the issue of the forced technology transfer seriously blocks the market entry and the business expansion of foreign companies in China by rendering the conduct of mergers and acquisitions difficult for multinational companies in the steel business and by putting them in a passive position when negotiating with Chinese partners.

A company in the *automotive industry* stressed that foreign-invested companies cannot participate in national or the vast majority of local government R&D programs or receive government R&D funding. Besides, it added that local government officials tend to offer attractive incentives to foreign-invested companies to invest in China, however, some of the promises cannot be fulfilled in a timely manner once investment is made.

According to a company in the *steel industry*, the presence of state-owned enterprises makes it difficult for foreign investors to enter this sector, especially in merger and acquisitions activities and concerning government procurement.

Detailed answers concerning the difficulties experienced by investors in China were in particular given concerning two sectors.

Firstly, a respondent raised a number of issues regarding the transport sector – in particular in relation to rail transport citing a clear policy of technology transfer and local content requirements to ensure protection of local industry. Furthermore the sector seems to be prone to increasingly burdensome licensing procedures for foreign suppliers. These together have prevented foreign companies effectively from bidding on public transport contracts. The respondent also raised the issue of the protection of intellectual property rights, claiming that China is reported to be filling patent applications in several foreign countries (ex US, Brazil) on technologies that were originally provided by foreign suppliers. Finally, the respondent indicated that the currency restrictions create limits on profit repatriation.

Secondly, the trade association representing the recording industry worldwide (IFPI) mentioned an important number of investment barriers in the *recording industry*. Some sectors are entirely closed to foreign investors, according to the draft Investment Catalogue. Foreign companies are thus prohibited from investing in the business of publication and production of audiovisual products and electronic publications, in addition to be prohibited from setting up any digital or online music services. There are also foreign ownership limitations in the sub-distribution of audiovisual products and in value-added telecommunication services. The trade association then reported that the foreign record companies are being discriminated against because of the censorship regimes for both physical and digital formats of foreign sounds and video recording. Finally, foreign record companies are facing unclear and obscure procedures to apply for a permit or approval to import or distribute foreign audiovisual products.

7. *Question: Please rank the five investment barriers that you consider the most problematic in China (from 1 – the most problematic; to 5 – the least problematic)?*

In accordance with the difficulties described by the respondents in their replies to the previous question, four investment barriers appear to be the most problematic for companies investing, or tying to invest in China: **licensing requirements/procedures, foreign ownership limitations, regulatory approval procedures, prohibition to invest/limited scope of business and joint venture requirements**. If we consider that the licensing requirements and the regulatory approval procedures can be regrouped into one category, then it appears clearly that in the respondents' view, the difficulties that they are encountering in the Chinese market are not only linked to the access to this market (which is limited by the three other barriers mentioned), but also to the implementation of the rules and the transparency/clarity of the Chinese policies. Appearing next in the respondent's ranking of most problematic barriers are the subsidies enjoyed by Chinese companies and the technology transfer requirements, which are specifically addressed by questions 17 and 10 respectively. Finally, other barriers mentioned included: local partner requirements, registration requirements, tax measures, excessive capital requirements, nationality/residency requirements, national security control, and problematic requirements for qualification.

8. *Question: Have any barriers that you have encountered deterred you from going through with plans to invest in China?*

9 respondents stated that barriers encountered deterred them from going through with plans to invest in China. For instance, a small company operating in the food trade business indicated that excessive capital requirements stopped it from expanding further its investments in China. Moreover, a large company in the steel industry stated that the joint venture requirements made them restrict their investment plans to areas open to wholly foreign-owned enterprises, because they feared a forced technology transfer. As a result, they were not able to invest in their core business (specialty steel manufacturing). Another large company in the same sector indicated that it had decided to make new investments in Taiwan instead of investing further in China, because of their fear to be copied.

9. Question: *Have you experienced any unfair treatment in connection with your investment in China?*

17 business respondents (50%) claim to have experienced a form of unfair treatment in connection with their investment in China. In their replies, the respondents report a general asymmetry of treatment with local companies, notably in terms of foreign ownership limitations and joint venture requirements, as well as concerning tax benefits. In the *automobile industry* a company pointed out the new proposed restrictions on foreign investment in key new energy vehicles component manufacturing as a form of unfair treatment. A company from the *steel industry* stated that a State-owned enterprise can get policy and financial support when merging with small steel companies. In the *textile industry*, EURATEX, a large trade association, indicated that local companies that are directly or indirectly supported by the authorities have a competitive advantage as they have faster and more efficient ways to deal with the regulatory and bureaucratic procedures. Without a local partner, investment procedures are more complex and take longer and this is even more evident if the foreign company is a small or medium enterprise and thus not considered by local authorities as a "strategic investment". Finally, the EU Chamber of Commerce in China recalled that in its 2011 Business Confidence Survey, firms reported that they viewed government policy towards FIE as becoming increasingly unfair, and also that they expected this development to continue in the future.

10. Question: *Have you experienced any issues linked to the protection of your key technologies when investing in China?*

13 business respondents (38%) stated that they have experienced issues linked to the protection of their key technologies when investing in China. Among those respondents, many of them complained of issues linked to copying. A company producing copper products stated that local companies had copied their brochure and modus operandi. A large automotive supplier reported that the company had encountered trademark/patent infringement and counterfeiting issues which resulted in a loss of know-how associated with high attrition. One large company in the steel industry stated that their plants have been copied in a very short period of time. Finally, in the textile industry, a big trade association stressed that copying and counterfeiting in China are key problems for its sector, because parts of its members' competitive assets are related to creativity and to the protection of designs and models. The association added that even if Chinese legislation and the public authorities' awareness of this problem are improving, they still faced serious threats and this was a factor that discouraged investment. Another trade association in the services sector indicated that its members encountered frequent violations of intellectual property rights in China. Beyond the infringement of IPRs, the procedures to assign and enforce those rights were also criticised by respondents. A company in the pharmaceutical industry stated that any assignment of intellectual property rights by a Chinese entity to an offshore entity will need to be registered with the MOFCOM which puts an extra burden on companies. Finally, the issue of technology transfers requirements was raised by a few respondents, notably by a company in the steel industry, which stressed that technology transfer requests are always part of cooperation discussions.

11. *<u>Question:</u> As an investor, how do you usually deal with legal conflicts in China?*

The respondents' most common approach to dealing with conflicts in China by far was amicable settlement. Only then did some respondents say they would respond with "end of contract/cooperation" as well as recourse to local legal proceedings. The replies received to the next question about the respondents' level of confidence in the Chinese legal system help explain why this way of dealing with legal conflicts in China only appears as a third choice in the respondents' answers, followed closely by recourse to "international arbitration" and "diplomatic support".

12. *<u>Question:</u> Do you have confidence in the Chinese legal system to protect your rights as an investor?*

80% of the respondents who expressed an opinion on the Chinese legal system said that they did not have confidence in it to protect their rights as investors. They explained that the Chinese legal system lacked transparency and consistency, both in the decisions and in the judicial process itself. They indicated that there was a gap between the written laws and their application and enforcement. Some respondents pointed at the existing bias towards local companies, stating that the Chinese courts and authorities are reported to be usually not neutral towards foreign companies. Finally a number of respondents stressed that the legal decision process was subject to political pressure, both from the local SOEs and from the administrative agencies at central, provincial and municipal level, which have a strong discretionary power to decide on foreign investment policies.

13. *<u>Question:</u> Would you consider starting international arbitration proceedings against the People's Republic of China on the basis of an investment treaty in the case of unfair and discriminatory treatment, or expropriation without compensation, of your investment?*

40% of the respondents who answered this question indicated that they would consider starting arbitration proceedings against China. While those of the respondents who answered “yes” did not give specific explanation, it is however interesting to look at the justifications brought by those who answered that they would not consider starting international arbitration proceedings against China. Several of them feared that starting such proceedings would prevent them from doing business again in China, or that it would impact other investments that they already had made in China. Others stated that such proceedings took too much times, resources and energy, therefore they would rather focus on projects with higher success rates. Other companies said that they would only start those proceedings in cases of complete expropriation, because this kind of legal complaint would seriously deteriorate the relationship with the State.

14. *<u>Question:</u> Have you ever used the provisions of any existing bilateral investment treaty to defend your rights as an investor?*

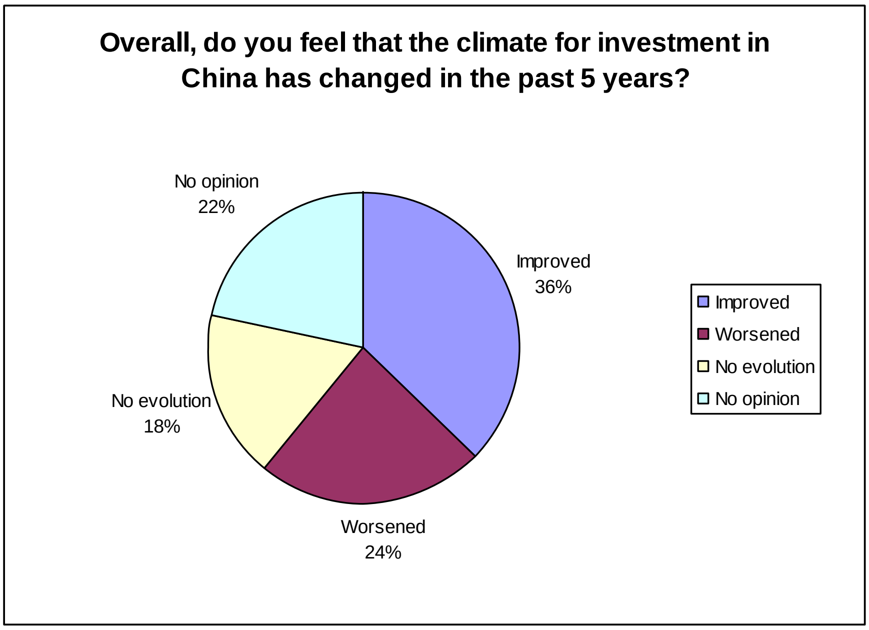
If you answered Yes: Have you ever used the provisions of a bilateral investment treaty concluded between an EU member state and China to defend your rights as an investor?

6 respondents stated that they have used the provisions of an existing BIT to defend their rights as investors in the past, but the information given about these legal cases is confidential. However it does not appear from the replies that any respondent ever used the provisions of a BIT between China and an EU Member State.

B) Questions for all respondents:

15. <u>Question:</u> Overall, do you feel the climate for investment in China has changed in the past 5 years?

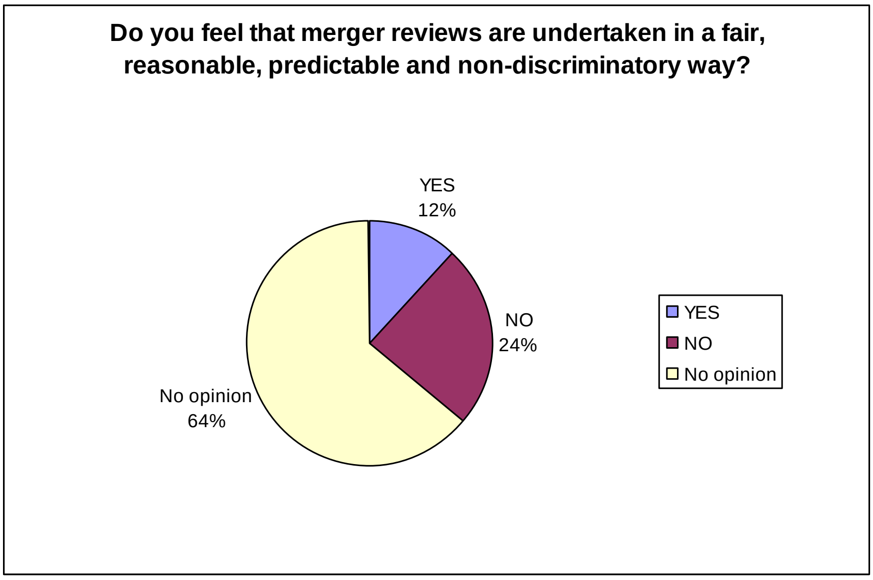
36% of the respondents felt that the investment climate in China had improved for the past 5 years, whereas 24% of the respondents felt that it had worsened.



In terms of improvement, respondents mentioned China's accession to the WTO and the economic reforms that occurred in the process. In general, they perceived a general modernisation of China's behaviour towards business. As a result of this evolution, they felt that the general investment climate had improved, but unevenly across sectors. Other respondents indicated some improvement concerning the scope of business for foreign investors in China. While a few of them mention a wider range of industry sectors now open to foreign investment (e.g. wine, steel), others pointed out the allowance of greater shareholding to foreigners in Chinese companies. The assessment of the evolution of the investment climate in China is therefore closely linked to the sector the respondents represent.

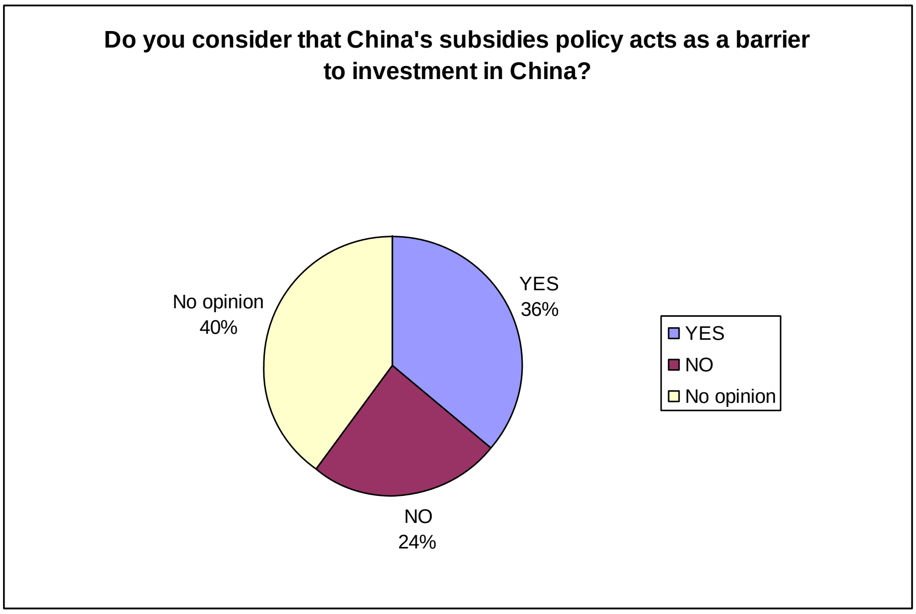
In terms of worsening, a few respondents believe that a "reform fatigue" phenomenon has taken place in China, with a general slowing down of reforms. Moreover, they stressed the relative implementation of the WTO commitments (e.g. intellectual property rights enforcement). They indicated that there were a lot of remaining issues across sectors, for instance the uncertainties, the lack of transparency and the sudden changes in policies that impact the companies' activities. For instance, a respondent mentioned the sudden change in the Social Insurance Law, to be effective in July, which requires companies to substantially increase their contribution to employee's insurance. A number of respondents stated that certain policies (e.g. indigenous innovation measures, preferential financing conditions, licensing and regulatory procedures) have the effect of discriminating against foreign owned companies in favour of domestically owned companies. Moreover, these kind of policies seem to be part of a more general evolution that saw a recent increase in China's protectionism (persisting non-trade barriers, technology transfer obligations, on-going restrictions to foreign investments, access difficulties to public procurement, indigenous innovation etc.) and its desire to create national champions (subsidies, preferential treatment for SOEs). In the automotive sector in particular, a large company stressed that the new draft Catalogue limits foreign investment in key new energy vehicle component manufacturing to joint venture with no more than 50% ownership by the foreign partner. They state that this policy forces foreign companies in key new energy vehicle components to partner with Chinese companies that do not have equivalent capabilities in the area.

16. Question: *Do you feel that merger review and merger review procedures are undertaken in a fair, reasonable, predictable and non-discriminatory way?*



A good share of the respondents (notably those who were not companies having invested in China), did not have an opinion on those procedures (64%). However, **among the respondents who expressed an opinion on the Chinese mergers review procedures, 2/3 of them raised concerns regarding this process**. Those concerns related mostly to the lack of transparency and predictability that surrounds the mergers review procedures, which, in addition to be long, also entails undue delays. One of the respondents thus stated that the approval of its joint venture had been delayed for 2 years for no reason. The procedures followed vary according to the province concerned, which adds to the confusion. Other respondents raised the issue of the participation of Chinese competitors in the *ad hoc* committee performing the review, which reinforces the general suspicion that mergers reviews are used as a means of protecting domestic players and discriminating against foreign-invested enterprises. Respondents expressed general concerns about the fairness of the merger review process. One of the respondents stressed that the approval process for the merger between Motorola and Nokia Siemens Network, although approved by antitrust agencies in 8 countries, was unduly delayed by Chinese authorities. Another respondent referred to the Coca-Cola/Huiyuan merger approval process as a case of discrimination against foreign investors. Finally, some respondents indicated that they had concerns about the impact on the merger approval process of the recently release national security review mechanism.

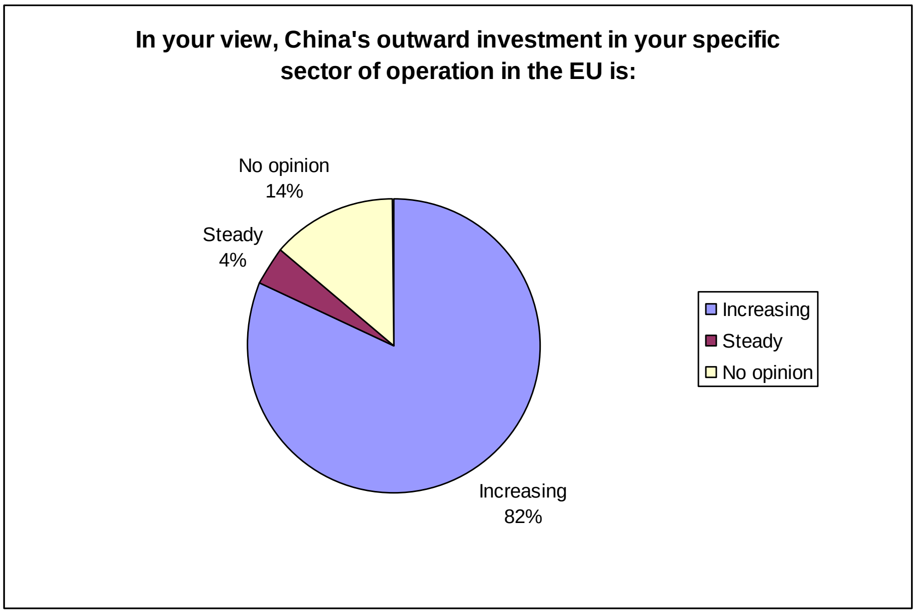
17. Question: *Do you consider that China's subsidies policy acts as a barrier to investment in China?*



As for the merger reviews procedures, a good share of respondents did not have an opinion on China's subsidies policy (40%). However, **60% of the respondents who expressed an opinion considered that China's subsidies policy acts as a barrier to investment in China**. As a general remark, subsidies policies were criticised by respondents for not being transparent. Moreover, a substantial number of respondents stated that subsidies largely favoured Chinese companies (especially State owned enterprises), and that this distorted competition and created an unlevel playing field between foreign and domestic companies in China. Respondents also indicated that subsidized companies had a strong financial advantage, especially in public procurement/bidding situations. State owned enterprises (SOEs) were notably often favoured in public tendering for projects and would not necessarily survive without subsidies. One respondent indicated that the unfair competition created by the subsidies received by domestic companies was particularly strong in the area of research and development. In the automotive industry for instance, it seems that the Chinese government provides substantial subsidies to domestic companies making new energy vehicles and components, whereas little subsidy is provided to foreign-invested companies in the same area. A trade association representing the interest of the automotive industry even indicated that the subsidies are granted exclusively to indigenous brands involved in new technologies.

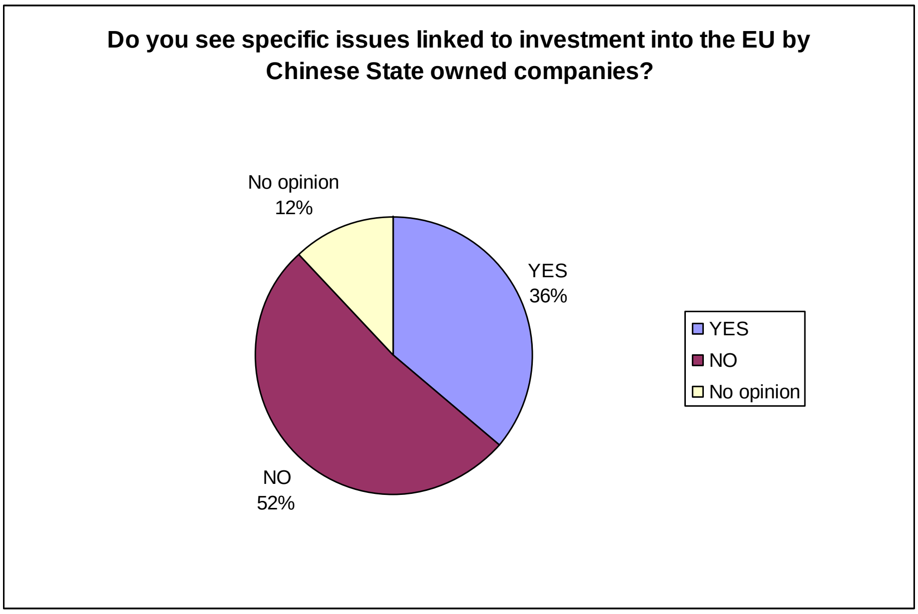
II) INVESTMENT ENVIRONMENT IN EU

18. *Question: In your view, China's outward foreign investment (i.e. Chinese companies investing abroad) in your specific sector of operation in the EU is:*
19. *Question Are there already Chinese companies that have invested in your sector in the EU that compete with you?*



Half of the business respondents (companies and trade association representing business) indicated that there were already Chinese companies that have invested in their sector in the EU and that competed with them. Moreover, **82% of the respondents felt that China's outward foreign investment in the EU in their sector of operation was increasing.** As an example, the French Permanent Delegation to the EU indicated that the Chinese outward investment flows in France amounted to 118 million Euro in 2009, compared to less than 20 million Euro in 2005.

20. *Question: Do you see specific issues linked to investment into the EU by Chinese state owned companies?*

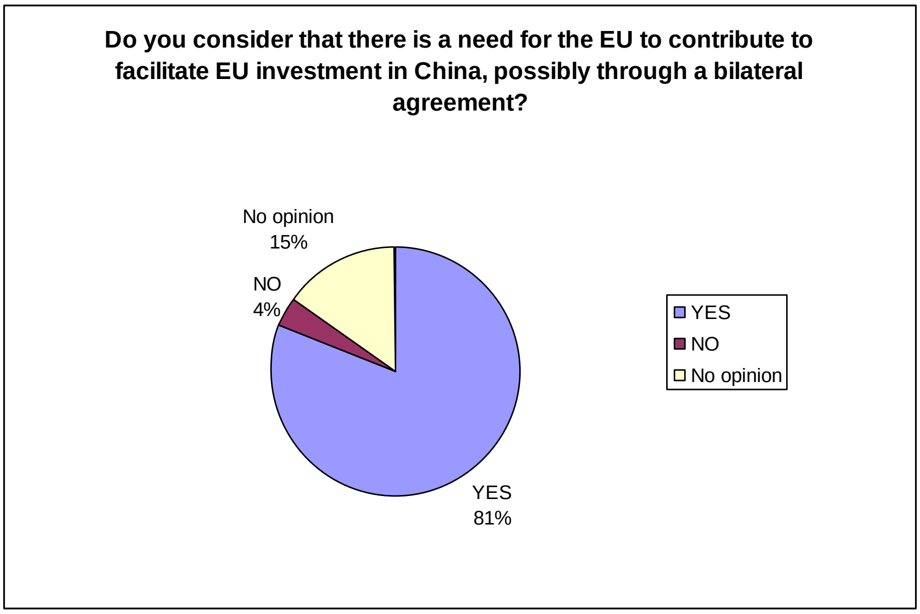


A majority of respondents (52%) did not see specific issues linked to investment into the EU by Chinese state owned enterprises (SOEs). Those of the respondents who expressed concerns stressed the unfair competition created by the differences in the situation of EU companies, which have to respect strict standards, and Chinese SOEs, in terms of prices, product quality, but above all concerning the subsidies received by those companies. A number of respondents advocated in favour of the application to these companies of the same competition rules that EU companies face when operating in the EU market, notably the EU anti-subsidies/state aid rules. They also pointed out that full transparency on the origin of the capital should be required from these companies. In particular, concerns were expressed by respondents that SOEs may benefit from the political and financial support of the Chinese authorities in public procurement tenders in the EU. As an example, one respondent mentioned the recent case of the public contract awarded to the Chinese SOE COVEC (China Overseas Engineering Group) by the Polish government due to a tender far below the minimum price expected, thus raising a debate about unlawful dumping practice. Finally, some respondents expressed concerns linked to the Chinese SOEs' investment in key technologies or critical infrastructures.

III. POTENTIAL IMPACTS OF AN EU-CHINA INVESTMENT AGREEMENT

A. Impacts on the investment climate

21. *Question: Do you consider that there is a need for the EU to contribute to facilitate EU investment in China, possibly through a bilateral agreement?*

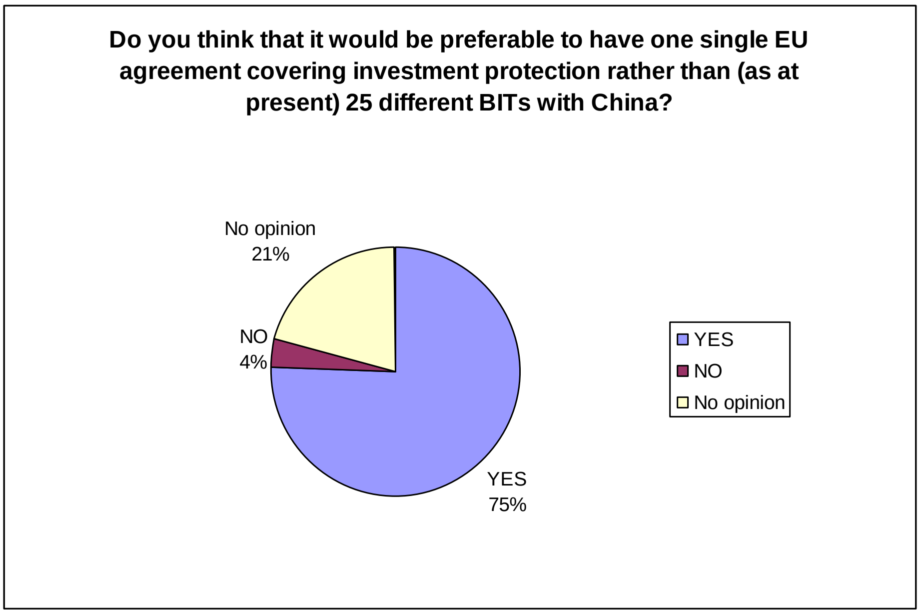


A very large majority (81%) of respondents considered there to be a need for the EU to contribute to facilitate EU investment in China, possibly through a bilateral agreement. Most of the respondents stated the need to ensure better access to the Chinese market for EU investors and to improve the legal framework for EU investors in China, by creating more stability and gaining better investment protection. According to them, an EU level initiative would contribute to eliminate unfair competition and raise general issues of concerns without affecting the status of EU companies affected. It would also contribute to increase clarity and predictability of the investment environment in China and the implementation of laws and commitments. Finally, for a few respondents, an EU level agreement could be a way of gaining more negotiating power and have more influence, also on other aspects, like environmental and labour policies in China. The two respondents who gave a negative answer did not give specific explanations.

22. Question: *Are there any specific issues that EU-China investment cooperation should focus on for facilitating EU small and medium enterprises' (SMEs') investment in China?*

A majority of respondents (51%) thought that there were specific issues that EU-China investment cooperation should focus on for facilitating EU Small and Medium Enterprises investment in China. A large number of respondents stated that in general, the barriers encountered by SMEs in China were the same as the ones encountered by large companies, but those barriers were even more problematic for SMEs, which do not always have the financial and human resources needed to bear long and expensive administrative or legal procedures. They mentioned a number of issues that are specifically difficult for SMEs: financing (notably the access to local banks), capital requirements, the procedures to set-up a company, visa restriction, double taxation, the lack of legal support/advice, regulatory controls and licensing requirements, the issue of intellectual property rights protection/enforcement and unfair competition with local SMEs. A respondent company pointed out the need for simplified rules, for instance a website in China with online payment for European SMEs, and reciprocally for Chinese SMEs in EU. EURATEX, a large trade association in the textile sector, stressed that the existence of focal points of information and assistance for SMEs was of key importance. It also insisted on the importance of cooperation and joint projects between EU and China, like the ongoing EU-China Trade Cooperation project. Another large trade association, BUSINESSEUROPE, stated that there had been recently some positive initiatives by the European Commission to give advice on investment and market access conditions for SMEs, such as the recently launched EU SME Centre. The association advocated for synergy effects to be triggered through effective coordination and cooperation between this Centre and other already existing help desks or European business service providers, notably at national level.

23. *<u>Question:</u> Do you think that it would be preferable to have one single EU agreement covering investment protection rather than (as at present) 25 different bilateral investment treaties with China?*



75% of the respondents thought that it would be preferable to have one single EU agreement covering investment protection rather than the present 25 separate BITs with China. Several respondents indicated that an EU-China agreement could contribute to clarifying the legal and operational framework for EU investors in China, and vice versa. They added that an EU bilateral investment treaty (BIT) would allow for more transparency and better implementation as well as enforcement of policies, thus increasing efficiency and improving business confidence. In addition, a large number of respondents stated that such an EU-level investment agreement would ensure a balanced treatment between all EU companies by harmonizing the protection standards. The general idea expressed by a large number of respondents is that the EU should have BITs with major countries, including China, provided that the level of protection as at least equivalent to the "best" BITs concluded by the Member States and that such agreement would not negatively affect existing rights of investors provided in existing BITs.

The views of respondents were however quite split in terms of the content and scope of a potential investment agreement. A trade union pointed out that an agreement would be an opportunity to advance recognition by both Chinese authorities and EU investors of the application of minimum social benefits in accordance with the law of the EU and the Protocol on Economic Social and Cultural rights ratified by China. A trade association also mentioned the need to cover the enforcement of international standards regarding child labour, environment, and anti-corruption. On the other hand, according to the European Services Forum and the Foreign Trade Association, the approach adopted should be based on practical considerations on strengthening commercial investment protection offered by the existing member state BIT network and not upon a purely abstract notion of a single EU-China agreement. Such negotiations should not in any cases diminish the existing protection and should not drag on for a long period. They also stated, along with other trade associations, that unrelated investment issues (human rights, labour conditions, etc.) should not be introduced into the negotiations. These non-commercial issues are not dealt with in the existing EU Member States' BITs and hence should not be part of a possible EU agreement (*see also the replies to the questions on the impacts of an EU-China agreement*). According to the EU Chamber of Commerce in China, an EU-China investment agreement should focus on creating a fair market environment. The EUCCC stressed that there would be a substantial positive impact only if market access were a key component, adding that specific concerns should be targeted, instead of having general statements and blanket coverage, and that there was also a need to ensure a full implementation.

24. <u>Question:</u> *Do you believe that there is a need to cover other aspects/standards relating to protection of investment currently not included in existing bilateral agreements?*

Several respondents, particularly trade associations, began by mentioning the <u>common standards relating to investment protection</u> generally included in BITs and which of these they would also like to find in an EU-China investment agreement: broad definition of investment, fair and equitable treatment, non-discrimination, investor to state dispute settlement with specific and limited time-frame, prompt, adequate and effective compensation in case of expropriation or measures of equivalent effect. They also stressed the need to ensure <u>better transparency</u> in the Chinese investment rules and policies, as well as the need to promote a <u>dialogue on investment facilitation</u>. Several respondents pointed out that such an agreement would need to focus on <u>implementation and enforcement of the commitments</u>, especially at the local level.

<u>Intellectual property rights</u> and their enforcement were also often mentioned as a specific issue to be addressed through an investment agreement with China. In the *pharmaceutical industry* notably, a large company called for an improved regulatory data protection from 6 to 10 years in order to create a level playing field between Chinese and European pharmaceutical companies.

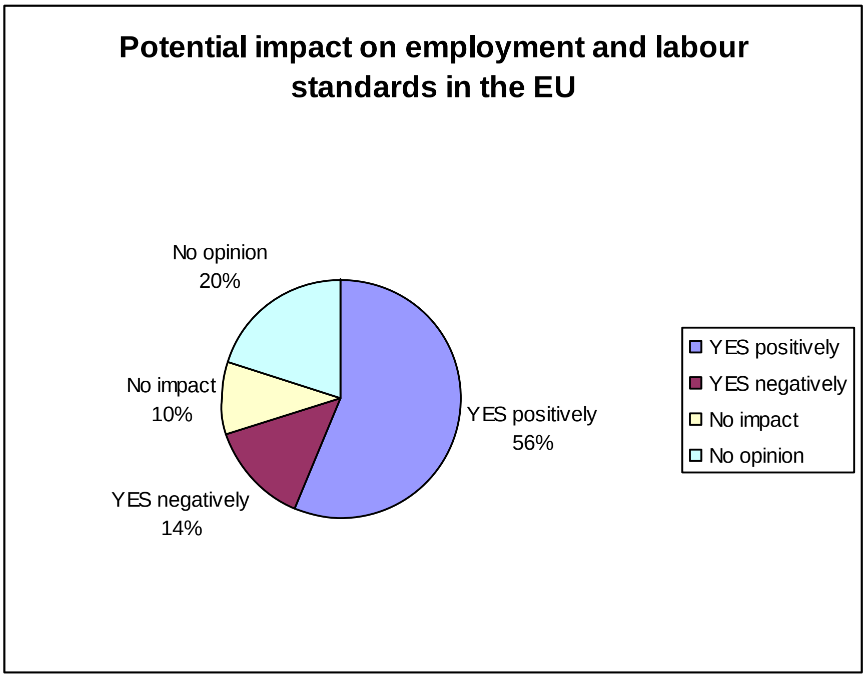
In the *automotive industry*, a large company stated that an EU-China investment agreement should aim to take out the restriction to foreign investment in key New Energy Vehicles component manufacturing, treat foreign-invested companies (FICs) equally with domestic companies and allow FICs to compete with domestic companies in government research & development programs and funding.

Finally, a trade association representing the interests of the *electrical and electronic industry* indicated that a bilateral agreement should focus on the protection of intellectual property and the recognition of international standards for imported products, in addition to fostering the access to public procurement in China, both on the state and local levels. It also stressed that a bilateral agreement should address the issues of transparency in the administrative procedures and the compliance with basic competition and labour laws (notably corporate social responsibility requirements).

B. Social and labour aspects

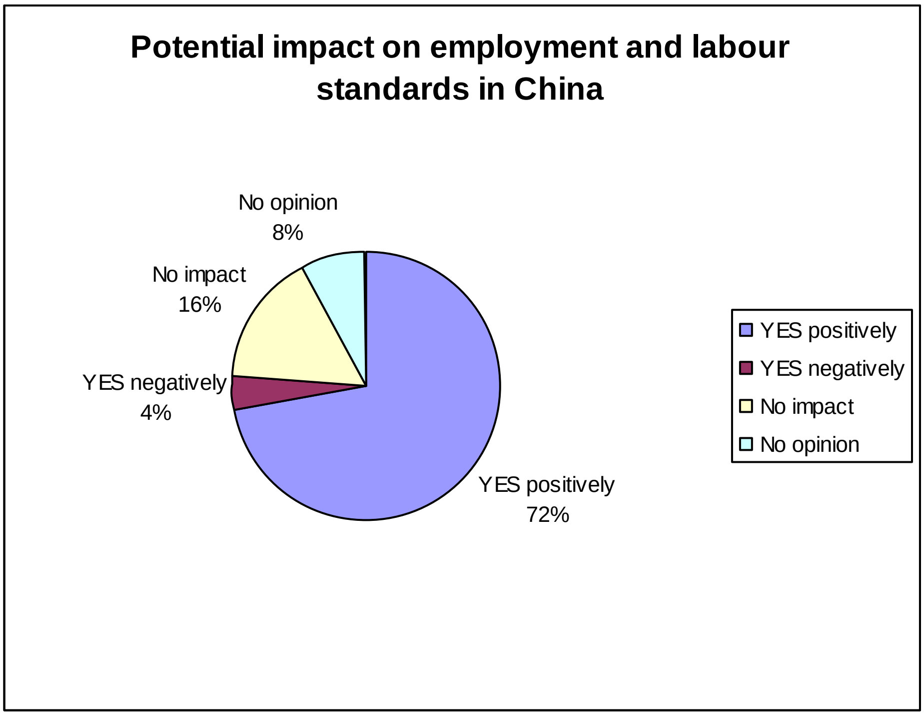
25. *Question:* *Do you think that employment (both the number and the quality of jobs) could be affected as a result of an EU-China investment agreement?*

a) In the EU



56% of the respondents thought that employment and labour standards in the EU could be positively affected by an EU-China investment agreement. 14% of them believe that employment would be negatively affected in the EU, 10% that it would not be affected and 20% did not have an opinion on this issue.

b) In China



72% of the respondents thought that employment and labour standards <u>in China</u> could be <u>positively</u> affected by an EU-China investment agreement. 4% of them believe that employment would be negatively affected in China, 16% that it would not be affected and 8% did not have an opinion on this issue.

In terms of <u>positive impacts</u>, a large number of respondents stated that in their view, an EU-China investment agreement would create employment opportunities, both in the EU and in China, due to the increase of investment activities. Moreover, they thought that an intensification of the investment flows between the two areas would lead to an increased demand for know-how and expertise and the creation of more qualified jobs. Beyond the effect on the level of employment and qualification, several respondents also thought that this agreement could have a larger impact on social and labour standards in China, influenced by EU standards. Indeed, they stressed that EU companies investing in China would bring along their best practices and apply them to their local activities, including better labour standards, safety and health conditions, training, corporate governance, etc.

Some respondents however suggested that an EU-China investment agreement could have <u>negative impacts</u> on employment and labour standards. In the EU, they expressed concerns that this agreement could encourage companies to relocate to China because of lower labour costs and that this could lead to a transfer of employment from the EU to China. They also feared that an increase of Chinese investors could result in a lowering of the EU labour and social standards due to the pressure from Chinese competitors. Concerning China, some respondents pointed out that better skilled workers could emigrate more easily from China to the EU and this could result in a loss of know-how for China, as a consequence of the concentration of qualified jobs in the EU.

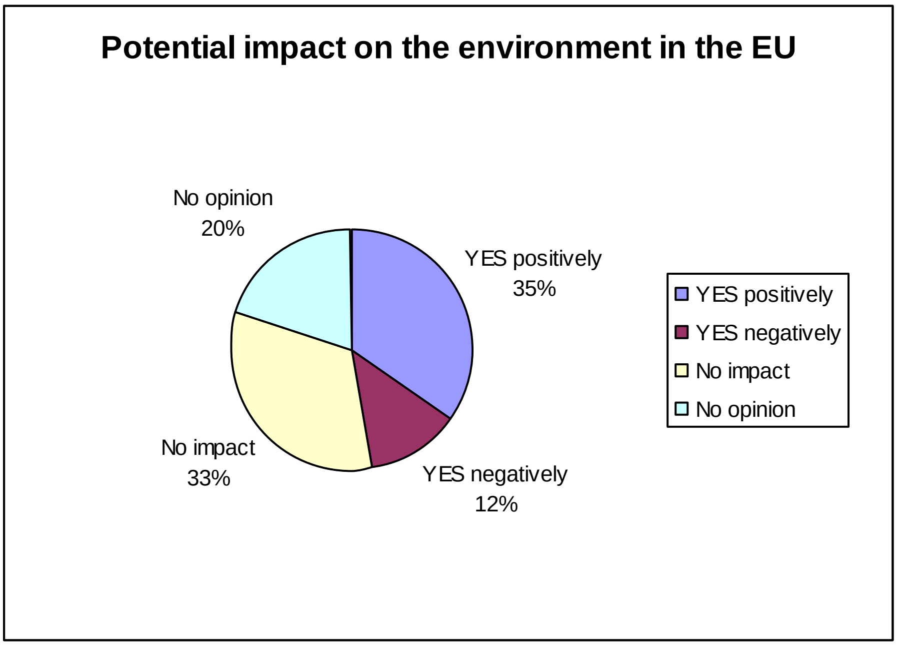
26. *<u>Question:</u> In your view, which issues linked to social and labour standards would require specific attention, in the context of an EU-China investment agreement?*

A number of respondents stated that in order to level the playing field between the two areas, a set of core labour and social standards should be accepted by both parties and included in an investment agreement. A number of issues and standards were mentioned as being potentially integrated in this set, e.g. working conditions (hourly wage, hours worked), workers' rights, child labour, social security, safety, healthcare and pensions. A few respondents stressed the need to protect the EU social system, while other stated that work and residence permits should be addressed in the agreement. Expressing a similar view as a small group of respondents, one large company from the chemicals industry stated that in order to implement internationally recognized labour and social standards and to ensure a level playing field for all economic actors, the recognition of international conventions (e.g. the OECD Guidelines for multinational enterprises, the ILO conventions, the United Nations Covenant on Economic, social and cultural rights) should be part of an EU-China agreement. However, the views on the possible inclusion of social and labour standards into an investment agreement were split overall, as several respondents took the opposite view, stating that social and labour issues were outside the scope of an investment agreement and should not be covered (e.g. European Services Forum, Foreign Trade Association, Eurochambres).

C. Environmental aspects

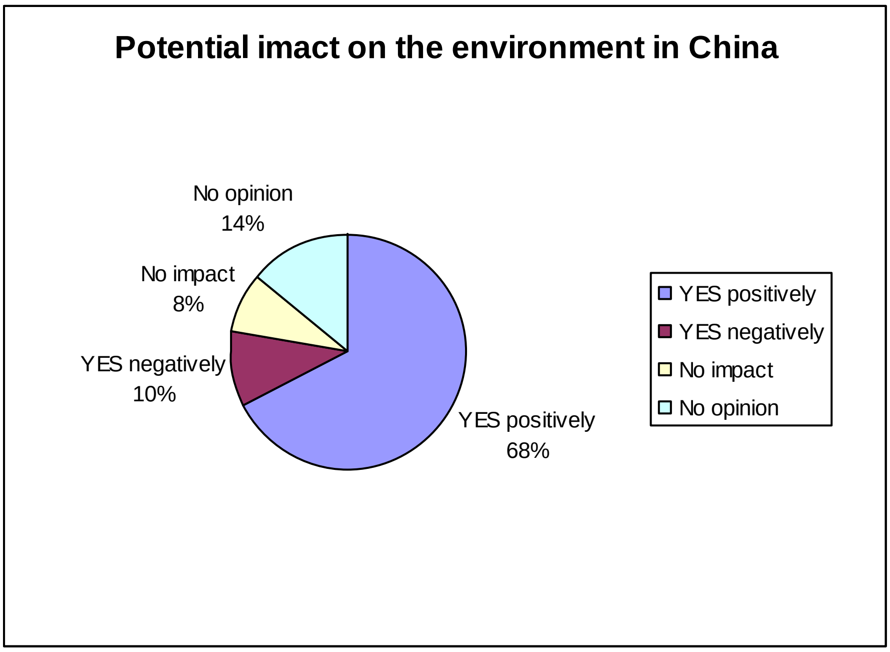
27. *Question: Do you believe that an investment agreement with China could affect the environment?*

a) In the EU



68% of respondents thought that an EU-China investment agreement could have a positive or a neutral impact on the environment in the EU. 12% of them believe that the environment would be negatively affected in the EU, 20% did not have an opinion on this issue.

b) In China



68% of respondents thought that an EU-China investment agreement could have <u>a positive impact</u> on the environment <u>in China.</u> 10% of them believe that environment would be negatively affected in China, 8% that it would not be affected and 14% did not have an opinion on this issue.

In terms of <u>positive impacts</u>, a number of respondents stated that an EU-China investment agreement represents an opportunity to foster the integration, by both the EU and China, of sustainable development objectives by promoting environment-friendly technologies and the implementation of mutual standards. In the same manner as for social and labour standards, some respondents pointed out that EU companies investing in China would bring along better environmental standards and practices, notably the use of new clean technologies, and that those practices would spread to local companies through spill-over effects. More globally, numerous respondents believe that a better investment relationship between EU and China, using an investment agreement, would enhance the bilateral cooperation between the two areas, resulting in an increased transparency in policies and a better exchange of information. As a consequence, such an agreement could encourage China to improve its environmental policies, in particular, as some respondents suggested, if it contained environmental standards.

Regarding the <u>negative impacts</u>, some respondents indicated that the unilateral internalization of environmental costs by the EU could influence investment decisions towards a location with different environmental costing factors, resulting in an increased relocation of polluting companies to China. Those respondents also generally believe that if no global environmental standards were set and accepted by both parties, the result of an increase in the investment flows between EU and China could lead to a degradation of the environment in China (because of the relocation of the most polluting EU industries) and a pressure in the EU to lower the environmental standards (because of the increased competition from Chinese companies).

28. *Question: In your view, which issues linked to the environment would require specific attention, in the context of an EU-China investment agreement?*

In the same manner as for employment and social impacts, a number of respondents stated that in order to level the playing field between the two areas, a set of core environmental standards should be accepted by both parties and included in the investment agreement. Some respondents gave examples of the mechanisms that could be introduced, including duty and tax-exemptions on green products, better allocation of subsidies for research and development, corporate responsibility principles. A number of key issues were also mentioned, e.g. CO2, contamination of air, soil, water, health (faked or tainted food), pollution (water safety, air pollution), general living environment, recycling. In particular, several respondents stressed that the cost for direct emissions should be the same for the Chinese companies as for EU companies.

29. ***Question: How could the EU and China seek to better integrate sustainable development considerations in their discussions on issues that concern their investment relations?***

Some respondent stated that environmental standards should be integrated in an EU-China investment agreement as well as commitments to implement multilateral agreements on the protection of the environment. They also advocated for this agreement to integrate periodic environmental impacts assessments, review mechanisms, legal liability of companies in case of damage to the environment, and real control mechanisms. The reply to this question by the NGO APRODEV, in particular, stated that an EU-China investment agreement should promote sustainable development in its three dimensions, economic, social and environmental, as well as the attainment of the Millennium Development Goals. The association stressed that such an agreement should not undermine governments' right to regulate and to apply domestic policies (e.g. positive discrimination, economic and women empowerment programmes, climate mitigation, etc.). APRODEV believes that the EU should use this investment agreement to promote and improve the monitoring of the conduct of European firms in the Chinese market, and of Chinese firms in the EU market, for example, with regard to taxation, financial reporting, anti-corruption, compliance with the OECD guidelines for Multi-national enterprises. In terms of renewable energy and climate mitigation measures, APRODEV believes that knowledge sharing rather than protection of intellectual property is needed to respond these global challenges.

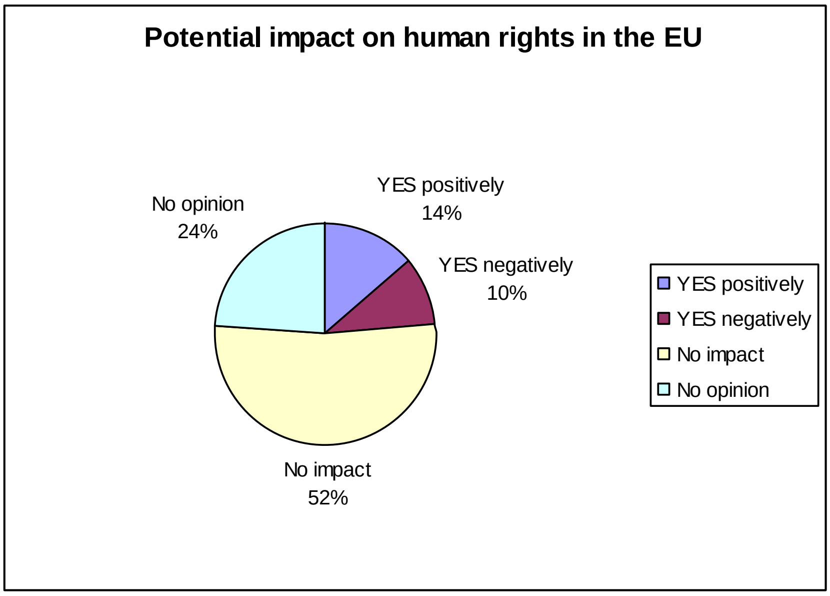
However, the views of respondents on the integration of environmental standards and mandatory requirements were as divided as those on social and labour standards. For several of the major trade associations, an integration of sustainable development considerations needs to be a natural outcome of the investment, and they believe that mandatory requirements concerning environment should not be included in an investment agreement. They stated that there are other fora to deal with environmental policy issues. The only investment-specific issue that should be tackled concerns the application of environmental rules in a manner that discriminates against EU enterprises. Indeed, they stressed that it was necessary to ensure the equal treatment of domestic and foreign businesses in implementation, monitoring, and enforcement of environmental regulation. BUSINESSEUROPE, one of the trade associations, added that this investment agreement should not use wording or articles that have the effect of attracting investments by lowering environmental standards either in the EU or in China, and that Chinese investments into the EU must comply with European environmental legislation.

An alternative position, presented by the Automobile Manufacturers Association, favours the integration of sustainable development issues in the EU-China Partnership and Cooperation Agreement, to ensure that cooperation on the environment is reflected in the EU-China partnership. The association also stated that the EU investors have often faced challenges with conflicting Chinese environmental regulations, for example the imposition of emissions standards for vehicles at a time when Chinese refineries were incapable of providing high enough quality fuels to match the standards. Therefore, they believe that a dialogue on the coordinated implementation of environmental rules across affected industry sectors (with industry participation) could facilitate the introduction of new environmental rules. In general, several respondents stressed the need to promote regular dialogue at sectoral level and encourage transparency and information exchange.

D. Human rights aspects

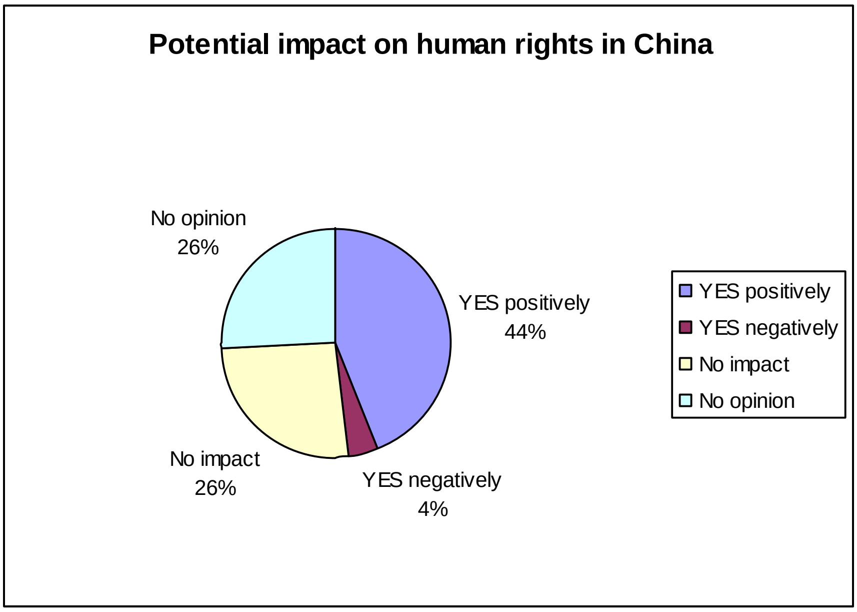
30. *Question: Do you think that human rights could be affected in the context of an EU-China investment agreement?*

a) In the EU



52% of the respondents thought that an EU-China investment agreement would have no impact on human rights in the EU. 14% of the respondents believe that the impact on human rights in the EU would be positive, 10% that the impact would be negative and 24% did not have an opinion on this issue.

b) In China



44% of the respondents thought that an EU-China investment agreement could have a <u>positive impact</u> on human rights <u>in China.</u> 26% of the respondents believe that such an agreement would have no impact on human rights in China, 4% that it would have a negative impact and 26% did not have an opinion on this issue.

Regarding the <u>positive impacts</u>, several respondents thought that an investment agreement was an opportunity for better cooperation and exchange of good practices and for influencing Chinese human rights policies. Other respondents added that bilateral investment agreement can positively influence the business relationship between the two areas which would lead to an increased exchange among people, contributing to a better and deeper common understanding also on fundamental issues. Moreover, they believe that fair and sustainable business relationships introduce more transparency and encourage companies to respect and promote human rights. A few respondents stated that the EU investors in China, bringing along their corporate standards and governance principle, would contribute to increase standards and cause spill-over effects for domestic companies. Other respondents stated that this agreement could have a positive impact on human rights in China if it includes specific provisions on human rights standards.

The <u>negative impacts</u> mentioned by a small number of respondents relate to a general pressure on EU practices and standards (e.g. unions, wages etc.) resulting from the increase possibility for EU companies to relocate in China.

31. ***<u>Question:</u> In your opinion, which issues relating to human rights might require specific attention in the context of an EU-China investment agreement?***

Respondents mentioned a number of issues to address in relation to human rights, some of which are also related to social and labour standards: <u>freedom of expression, freedom of the media (press and access to websites in particular), child labour, respect of labours laws and standards, better conditions for NGOs and the civil society, respect of the due process of law</u>, etc. The Austrian Federal Chamber of Labour stated that an EU-China investment agreement should reconcile the rights of investors with the policy space of states to allow for the protection and the promotion of human rights. The NGO APPRODEV stressed that transparency and accountability of business activities should be enhanced to avoid human rights violations, notably giving the OECD guidelines for multi-national enterprises the status of binding standards. They also emphasized that human rights should be included in the impact assessment process, which should provide for a monitoring mechanism that goes beyond aggregated data. On the contrary, several of the major trade associations stressed that human rights issues should not be included in an EU-China investment agreement because it could paralyse negotiations and potentially threaten or weaken the protection of EU investment abroad.

IV. OTHER ISSUES

32. ***Question:* If there are any other issues that are not mentioned in this questionnaire that you would like to address, please use the space below to set them out.**

Very few respondents mentioned other issues. In particular, one large company, which started to invest in China more than 10 years ago, stated that treating a country the size of China as a single homogenous entity may sometimes over-simplify the specific situations in different areas with different development stages. It stressed that regional differentiation may be useful. Another large company pointed out that it was sometimes difficult to bring back dividends from China.

Public consultation on the future EU-China investment relationship
List of the contributors

(In **bold**: those who have accepted that their contribution be published).

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EU-CHINA INVESTMENT STUDY

SUMMARY OF REPORT | JUNE 2012

INFORMED DECISIONS

COPENHAGEN ECONOMICS

COLOPHON

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PREFACE

This study is produced by Copenhagen Economics under the terms of reference for the study entitled *''Assessing the impact of an EU-China investment agreement''* under framework contract (TRADE/07/A2).

EXECUTIVE SUMMARY

The Lisbon Treaty gives the EU the exclusive competence for foreign direct investment, and China has been identified as one of the potential partners for an investment agreement in the July 2010 Communication on EU future investment policy[i]. This study assesses the economic impacts of such an investment agreement with China.

BACKGROUND

Foreign direct investment (FDI) is a main contributor to economic growth. It creates jobs, increases productivity by allowing the transfer of technology, skills and knowledge, and it can boost trade. The EU is a large foreign investor with outward extra-EU stocks of FDI amounting to 4.2 trillion Euros by 2010 while EU inward stocks (extra-EU) accounted for 3.0 trillion Euros in the same year according to Eurostat.

China and the EU are key trading partners, but investment flows between the two regions remain limited in comparison. The stock of EU-owned foreign direct investment in China has increased from €21 billion in 2004 to €75 billion in 2010, corresponding to an average annual increase of 25 procent. Still China only account for 1.8 percent of total outward extra-EU FDI. Stock of Chinese FDI in the EU27 has increased from €2 billion in 2004 to €7 billion by 2010, which corresponds to an annual growth of 23 percent. The stock of Chinese FDI in the EU is still very small compared to the overall amount FDI in the EU27 from non-EU countries. China's investments only account for 0.2 percent of the total inward stock in the EU27 by 2010.

POLICY OPTIONS ANALYSED

With the rapid growth in China's outward investment, currently just over half the size of the inward stock, China soon will become a net exporter of FDI. According to estimates in Rosen and Hanneman (2011), China's outflow of FDI could reach between $1 trillion to $2 trillion by 2020.

With the prospect of increasing outwards investments, China has expressed an interest in obtaining a unified level of investment protection at the EU level in this context. The current legal framework comprises a patchwork of 25 so-called bilateral investment treaties (BITs) between Member states and China.

At the same time, EU investors often face multiple barriers to their establishment and post-establishment operations in China, as well as discriminatory treatment in China, while the EU market is perceived more open when it comes to Chinese investment in Europe.

Regarding the future EU-China investment relationship, DG TRADE can consider three broad policy options: first, a stand-alone investment protection agreement replacing the 25 BITs, second, a comprehensive investment agreement covering market access and investment protection, or finally not to make any separate agreement, with investment continuing to be covered by informal dialogues and WTO as well as broader agreements like the 1985 Partnership and Cooperation Agreement.

In this study, we have been asked to assess the two first options in order to compare with the “do nothing” option. The “comprehensive investement agreement” option has been split in two and we thus investigate three options:

- *Option 1* entails a basic 'investment protection only' agreement building on the existing BITs and thus creating a comprehensive EU level investment protection agreement.
- *Option 2* combines investment protection with market access, although with only limited sectoral coverage and partial removal of barriers.
- *Option 3* involves a comprehensive investment treaty containing provisions on full market access for investment for both services and non-services sectors and the most sophisticated level of investment protection standards.

MAIN FINDINGS OF THE REPORT

The report is structured in eight chapters.

Chapter 2: Current investment situation

In *Chapter 2*, we provide an analysis of China-EU FDI flows and stocks and their development over time. Looking at *the EU investments in China* we find that the EU stock of foreign direct investment (FDI) in China was €75 billion in 2010 according to Eurostat. China began its policy of opening up their economy to foreign investors in 1992, and the following two years, there was high political focus on attracting FDI to China. The FDI stock held by EU firms in China was very low prior to 1992, but following the opening of the Chinese economy, the EU FDI stock increased rapidly until around 2001 when the EU stock in China levelled off at around €20 billion. EU investment resumed growth again around 2004 with an average annual growth rate of the EU owned FDI stock in China of around 23 percent between 2004 and 2010. Today, EU FDI in China consists of almost equal parts manufacturing and services. At a more detailed level the investment in manufacturing is concentrated in chemicals, metal and motor vehicles, while real estate and finance dominate the service sector investments. Compared to Russia, where the

EU has invested heavily, China is lacking behind as destination for EU investment. Our analysis shows that China is underrepresented as destination for EU investment. Looking at *China's investment in the EU*, we find that in most EU countries with available data, the Chinese share of total extra-EU owned production value is 0.1 to 0.3 percent. While the investment from China in the EU is increasing rapidly, it is still less dramatic than the increases from other BRIC countries. Investments into the EU from Brazil and Russia are increasing much more rapidly and the investment stock from Brazil is ten times higher than from China. The Chinese investment in EU focuses mainly on services. Mining and agriculture only account for a very small fraction of total investment. On a more detailed level Chinese investment in the EU27 within manufacturing is concentrated in machinery, computers and communication equipment, while the investment in services is dominated by investments in the financial sector. We also highlight the role of state-owned enterprises (SOEs) in China's outward FDI. All of the ten largest Chinese MNEs by outward FDI stock are SOEs, and more than half are operating in the natural resources sector, according to the OECD. Our analysis of 33 Chinese investment projects in the EU recorded in the period 2006-2011, shows that 73 percent of the invested amounts were made by SOEs.

Chapter 3: Assessment of a protection only agreement (option 1)
In *Chapter 3*, we look at option 1 and assess the degree of protection provided by the current system of 25 BITs with China. It is a clear benefit for China to have only one single EU BIT providing clarity and protection for investors. We have also investigated whether an "investment protection only" agreement with China would provide added value in terms of ensuring a 'level playing field' for the protection of European investors in China. Here results are less clear. We find that even though the playing field is somewhat levelled by the MFN clauses in the BITs and by the possibilities for European investors to mimimize investment risks through corporate restructuring, investors are able to rely on higher standards of protection and more legal certainty in the newer BITs than those granted under an old generation BIT. Therefore on balance, a continuation of the current 25 BITs would retain an element of legal uncertainty and will depend on a case by case evaluation through an arbitration panel. As a consequence it should be held that the level of protection in a single EU level agreement would be legally more certain for investors from all 27 Member States than if maintaining the current status quo.

Chapter 4: Impacts of BITs on FDI flows

In *Chapter 4*, we ask the question “do BITs bite?” and whether BITs have a measurable economic impact on investment flows. To answer this, we review of the research on the impact of BITs. Our review of econometric and qualitative studies suggests that while BITs can be important instruments for the protection of investments, it is more uncertain how BITs impact the volume and destination of FDI. The econometric evidence on the relationship between BITs and investments is in our view mixed and without a clear consensus on the extent to which BITs should be expected to increase FDI. Empirical findings are extremely sensitive to the estimation method, particularly when it comes to handling the possible endogeneity problem i.e. the possibility that BITs are signed when FDI flows between the signatories are already large and/or are expected to increase. Based on the available evidence, we conclude that a consolidation of current BITs with China into one single EU-wide investment protection agreement that extends current “best-in-class” protections to all EU Member States would be unlikely to significantly increase FDI flows from the EU to China.

Chapter 5: Barriers to be addressed by FDI liberalisation (options 2 and 3)

In *Chapter 5,* we look at “a BIT with bite”, i.e. with investment liberalisation chapters as stipulated in options 2 and 3. Here we describe the investment barriers facing EU and Chinese investors. In Chapter 3 and 4, we came to the conclusion that a single “investment protection only” BIT with China will provide benefits by increasing the certainty of the investment protection. We also found that an “investment protection only” BIT should not be expected to lead to a considerable increase in investment flows. A BIT with more bite would include improved market access by reducing investment barriers and restrictions on investment in China. In Chapter 5, we show that there are significant investment barriers and that barriers for EU investors in China are higher than investment barriers for Chinese investors in the EU. We bring together hard data on EU investment flows with qualitative data from an inventory of Chinese investment barriers and the results of an investor survey conducted amongst EU investors in China in order to identify sectors of particular interest to the EU. We find that the following sectors are of particular interest: Financial services, construction services, automotives and electrical machinery, and the barriers in these sectors are discussed in greater detail. The chapter also addresses the barriers facing Chinese investors in Europe. We have found that there are substantial barriers to investment which hold back investments between the EU and China, and that FDI barriers are substantially higher in in China than in the EU.

Chapter 6: Possible benefits of FDI liberalisation (options 2 and 3)
In *Chapter 6*, we provide an analysis of the possible impacts of a liberalisation of investment barriers between the EU and China.

Impact from increasing outward FDI to China
Rising levels of *European outward FDI to China* is a concern for many policy makers and some parts of the European public. These concerns stem from the perception that the foreign activities of European MNEs might depress economic activity and reduce employment within the EU. Based on the existing empirical literature we conclude that EU outward FDI has made a positive and significant contribution to EU firms' competitiveness in the form of higher productivity. The productivity gains appear to be less pronounced for investments in less developed countries. EU outward FDI has so far had no measurable impact on aggregate employment. In fact, EU firms' investments out of the EU appear to have a positive impact on their employment and, over time, there is no indication that employment in the parent company is put under pressure by low wages in the host country of the foreign affiliate. Finally, outward FDI has redistributive impacts where skilled workers gain relative to unskilled workers. The few studies that compare redistribute impacts of FDI in developed and developing countries appear to be inconclusive.

Impact of increasing inward FDI from China
Increased levels of *Chinese FDI into Europe* could also be beneficial. We know from a range of other studies that increased inward FDI into Europe in general will enhance economic growth through productivity gains and higher employment. This will happen since these investments bring knowledge and new technologies to the EU firms and enhance competition. However, there may be reasons to believe that Chinese investments may entail less positive stimulus. Compared to FDI from more advanced countries such as the US and Japan, the productivity spillovers from Chinese FDI should be expected to be smaller. This is so because the bulk of Chinese FDI comes from SOEs, as shown in Chapter 2. This is important because studies find that Chinese industrial SOEs are less efficient than privately held firms and consequently fewer spillovers should be expected. However, as noted by Rosen and Hanneman (2011), Chinese companies are rapidly improving their performance and the emergence of efficient and globalised private firms from China suggests that EU companies may benefit from Chinese FDI in the future. This would imply over time inward FDI from China could the same positive macroeconomic effects in terms of increased competition, lower prices and higher consumer welfare as FDI from other countries. Also, Chinese firms operating in liberalised markets develop their own manufacturing

insights and positive spillovers are likely to materialise in the longer run. At the same time we acknowledge the risk that the Chinese investors may bring back technological know-how to China and use the knowledge to build Chinese companies that, over time, will be able to compete on the global market. This is a risk for all inward FDI projects but taking China's sheer size, the extent of state intervention makes China a special case.

Chapter 7: Quantifying the impact of FDI liberalisation on FDI (options 2 and 3)

In *Chapter 7*, we describe our quantitative economic analyses on the estimated impact of investment barriers on the level of EU investments in China. We have applied several econometric models to quantify the impact of reducing investment barriers on FDI between the two economies. We measure investment barriers by including different indicators of the investment climate in China and the EU, including the index of perceived restrictiveness based on new survey data. In our most conservative estimation (using so-called OLS estimator), we estimate that the EU stock in China could increase by 0.6 percent in the moderate scenario (option 2) and by 1.9 percent in the ambitious scenario (option 3) in the non-reciprocal scenario, where only China reduces FDI barriers. In the reciprocal case, where both the EU and China are reducing barriers, we estimate the Chinese FDI stock in the EU increases by 0.3 percent in the moderate scenario (option 2) and by 0.9 percent in the ambitious scenario (option 3). We find that these impacts are in line with the CGE results in the next chapter.

Chapter 8: Quantifying the economy-wide implications of FDI liberalisation (options 2 and 3)

In *Chapter 8*, we report the results from a model-based analysis of various scenarios for the reduction of investment barriers between the EU and China. As was the case for our econometric estimates in Chapter 7, we consider both cases where there is unilateral FDI liberalisation by China as well as reciprocal liberalisation with comparable concessions by the EU. The reciprocal concessions relate to possible further concessions by the EU itself, moving its own restriction indexes for China closer to those facing EU firms operating within the EU. Furthermore, we have considered that elimination of regulatory barriers may also yield improved access for third countries, when barrier reductions involve generic changes in regulatory barriers. In the CGE model, we therefore extend the modelling approach to also include third country spillovers.

Macro-economic results

Our simulations show a clear pattern of results where the most ambitious liberalisation (option 3) yields more substantial benefits than the modest scenario (option 2), not only for the EU but also for China. Indeed, in the case of the most modest scenario with very limited liberalisation and almost no spillovers, there is also basically no substantive effect on GDP in either for the EU or China. Another key finding from the simulations is that, for the EU, estimated gains are actually larger when the spillover effects are also larger, i.e. when FDI liberalisation in China has a large multilateral element. This follows from better demand conditions globally with greater Chinese FDI liberalisation, as well as better intermediate supply conditions in China with greater spillovers. The modest scenarios yield little benefit by the measures included in the model.

Possible environmental impacts
We have also assessed the possible environmental impacts in this chapter. On the overall level most of the scenarios shifts the output composition of EU MNEs in China in the direction of the generally more polluting manufacturing sector relative to the generally less polluting services sectors. It cannot, however, be concluded on this basis that there will be negative environmental impacts from the estimated changes in output. Using a recent classification “dirty” and “clean” industry sectors, we can qualify the direction of the change in sector output composition for EU firms in China in the various experiments. Our analysis at the more detailed composition of the manufacturing sector indicates, that for the identifiable “dirty” and “clean” sectors in the model, all but one experiment[86] point to a positive composition effect for EU MNEs in China, implying that the pollution intensity for European MNEs in China would decrease as a result of FDI liberalisation. This based on the composition effect alone, and additional environmental improvements could follow through other channels such a technology transfer and from the fact that MNEs generally apply stricter environmental standards than local Chinese firms. We have also evaluated the global impacts on carbon emissions in all scenarios (through the use of the CGE-model). On the basis of current patterns of trade and current technology levels we estimate the net global carbon impact to be negligible in the scenarios.

Labour market impacts
While there is only a very small positive or no impact on overall employment levels in the EU, the changes at the sector level are estimated to be more pronounced, but still moderate. In the reciprocal and ambitious experiment with high spillovers (scenario B), yields an overall positive

employment impact. In this case, we predict the following positive sector employment impacts in the EU (with the higher estimates relating to the flexible closure):

- +0.5 to +0.6 percent in the EU motor vehicle sector
- +0.3 to +0.4 percent in the EU transport equipment sector
- +0.5 to +0.7 percent in the EU electronic equipment sector

A number of other sectors are seeing more moderate positive effects of zero to 0.1 percent increase. Some sectors are shown to be negatively affected in the scenario (with the higher estimates relating to the fixed closure):

- ☐- 0.2 percent in the EU ferrous metals sector
- ☐- 0.4 percent in the EU other metals sector
- ☐- 0.2 to -0.1 percent in the EU metal products sector
- ☐- 0.2 percent in the EU communication services sector

Turning to the non-reciprocal and ambitious experiment with high spillovers, sector results looks different. The experiment still yields an overall positive employment impact of 0.03 percent as in the scenario above, but in the non-reciprocal case we predict bigger positive sector employment impacts in the EU, but in fewer and bigger sectors compared to the reciprocal experiment. Specifically we find (with the higher estimates relating to the flexible closure):

- ☐+0.1 to +0.9 percent increase in the EU chemicals, rubber and plastics sector
- ☐+0.2 to +0.7 percent in the EU machinery and equipment sector

Some sectors are shown to be negatively affected in the non-reciprocal scenario. In this case we predict the following negative sector employment impacts in the EU (with the higher estimates relating to the flexible closure):

- ☐0 to - 0.2 percent in the EU metals sector
- ☐0 to - 0.2 percent in the EU motor vehicles sector
- ☐- 0.4 to -0.9 percent in the EU transport equipment sector
- ☐- 0.4 to -3.2 percent in the EU electronic equipment sector
- ☐- 0.2 percent in the EU 'other manufacturing' sector

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[i] Communication from the European Commission (2010), "Towards a comprehensive European international investment policy", COM(2010)343 final, Brussels 7 July 2010 http://trade.ec.europa.eu/doclib/docs/2011/may/tradoc_147884.pdf