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EU-CHINA COMPREHENSIVE AGREEMENT ON INVESTMENT: POLITICAL AND ECONOMIC IMPLICATIONS FOR THE EUROPEAN UNION

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EXECUTIVE SUMMARY

- On 30 December 2020, China and the European Union concluded the negotiations of the Comprehensive Agreement on Investment (CAI). It is intended to replace bilateral investment treaties (BITs) between China and particular EU Member States. The EU and China have been in talks for seven years trying to reach agreement. The deal has yet to be signed and the text of the agreement still needs the approval of the Council of the European Union and the European Parliament.

- The deal was concluded mainly due to the determination of the German government, which wanted to score a diplomatic success while holding the presidency of the EU Council, and with clear political support from France. Germany was interested in keeping economic opportunities with China open, while France sought to demonstrate the Union's growing political clout. Both countries are also major investors in China.

- The signing and ratification process of the CAI could be problematic given the controversies regarding the Agreement. They concern mainly its political significance but also the effectiveness with regard to access to the Chinese market, the level-playing field, and implementation of provisions regarding sustainable development.

- The agreement plays an important political role in the complicated relations between the EU, the U.S., and China. Since the European Commission received its mandate for the negotiations of an investment agreement with China in 2013, the international environment, China's internal and economic policies, and EU-China relations have changed profoundly. In the "EU-China Strategic Outlook", published in 2019, in which the European Commission assessed the state of EU-China relations and presented its prospects, apart from being described as a strategic partner and economic competitor, China is defined as a systemic rival of the EU promoting alternative models of governance. In that regard, adoption of CAI could downgrade the systemic rivalry with China in the EU's strategic outlook. Moreover, completing the CAI negotiations by the end of 2020, just weeks before the start of the new U.S. administration, which declared a rededication to Europe, undermined the EU's potential political leverage in relations with China and, as a consequence, Europe's position on the global stage.

- CAI, in the form concluded in December 2020, is a blow to transatlantic cooperation vis-à-vis China and supports the latter in its rivalry with the U.S. However, some provisions in the agreement, such as on the services sector could be beneficial for U.S. companies, based on the WTO's most favoured nation rule.

- Through agreeing to certain concessions, albeit without legal instruments for the EU to guarantee implementation of the agreement, EU companies, especially those from Germany, France, and the Netherlands—the biggest investors in China—may be in a difficult situation if CAI is ratified and they decide to invest in certain sectors. China treats bilateral economic relations through a political lens and handles them instrumentally. With increasing economic power, China exercises the growing capacity to exert pressure on foreign governments and thus could violate economic agreements, such as the recent example of the one with Australia. Moreover, the finalisation of CAI must not result in muting criticism of China's human rights abuses and violations of international treaties.

- China's regulations concerning internal security, such as the State Security Law or Counterterrorism Law, which are not affected by CAI, or the implementation of a nationwide social credit system and tighter grip on the private sector through, e.g., growing requirements to establish party cells in enterprises (as mentioned in a recent study by the European Union Chamber of Commerce in China), could hamper EU companies' investment activities. Moreover, if China assumes wide interpretation of national security, practically every EU company's investment can be blocked.

- The EU's level of protection against China's competitive advantage resulting from restrictions on European companies' market access or other unfair practises will be patchwork and vary depending on the issue in question.

- CAI leaves out an investment protection section. Thus, the EU Member States' BITs will remain applicable for the time being, maintaining different levels of protection for EU investors. The two-year deadline to finalise the investment protection section is toothless—there are no real incentives to bring the parties to the negotiating table and make them seek consensus. So, in the end, CAI may fail to ensure equal protection of EU investors if China refuses to engage in meaningful negotiations.

- Due to the limitations of the enforcement mechanism, it is unlikely the agreement will provide effective protection against unfair regulatory competition with respect to ILO standards on forced labour, freedom of association, and collective bargaining, as well as environmental standards.

- Ratification of CAI will not provide decent protection and is weak on reciprocity. Moreover, China has additional tools for modifying the conditions on the ground according to its own interests. Under the increasing grip on the economy that the Chinese one-party state pursues, the unpredictability in doing business in China might even increase. This scenario is probable given that China has not implemented promised structural reforms and because its mixed compliance with WTO dispute rulings challenges the organisation's fundamental norms.

- The key issue regarding CAI's effectiveness is the dispute settlement mechanism, but it is incoherent (exception for subsidies, separate mechanism for sustainability provisions) and does not guarantee comprehensive implementation of the agreement. However, even an effective dispute settlement mechanism might not prove sufficient. Large investments are difficult to withdraw instantly and without losses. Investors themselves, under pressure from Chinese authorities, might be unwilling to report violations and discrimination out of fear of retaliation that may constrain their access to the large Chinese consumer market. Thus, in practise the CAI provisions depend on the confidence in the rule of law in China and the reliability of PRC institutions, which might provide quite weak safeguards for any investment or trade agreement. This may be assessed as insufficient in providing a safe and reliable investment environment that is consequently beneficial for EU investors.

- Before ratification of CAI, the EU should regain some leverage on China by insisting on ratification of the ILO conventions as a prerequisite, taking into account that the lack of implementation of CAI could hit the PRC. The EU could also demand changes to national laws regarding, among others, labour conditions, as happened in the case of a similar agreement concluded with Vietnam.

- The EU needs to put in place autonomous measures to defend European interests vis-à-vis China before ratification of CAI. This should include an international procurement instrument; a ban on the import of products of forced labour into the EU market; human rights due diligence legislation; measures against unfair subsidies on the basis of the EU's white paper of June 2020; the "bazooka" against economic coercion; and an enhanced investment screening mechanism.

Part I: Political Analysis

Evolution of the political context of the negotiations

On 18 October 2013, the European Commission (EC) received a mandate from the Council of the European Union to negotiate an investment agreement with China (later named the Comprehensive Investment Agreement, or CAI).

However, since that time, the relations between the EU and China have evolved significantly. In 2012, Xi Jinping became Secretary-General of the Chinese Communist Party (CCP) and Chairman of its Central Military Commission, and in March 2013 he was elected China's president at the National People's Congress. He thus consolidated all three major positions in the party and the country in his hands. That meant the beginning of a transformation in both Chinese internal and foreign policy, in three main dimensions: **1) centralisation of Xi's power** in the party apparatus along with providing the party more competences in the Chinese political system; **2) assertive diplomacy** towards partners and international organisations; **3) exploitation of globalisation** at the expense of other countries as the main driver of development.[1] None of these components were new initiatives, but under Xi all of them have been significantly strengthened. At the same time, they influenced the relations with the EU, both politically and economically during the seven years of CAI negotiations.

Centralisation of power

Xi Jinping has strengthened CCP competences in crucial areas: in business, state institutions, and massive control of society (marked by a high degree of digitalisation). The Party was flooded with anti-corruption campaigns targeting not only low and mid-level officials but also high-ranking former members of the CCP Politburo Standing Committee and other bodies. The anticorruption drive was also a mechanism to eliminate Xi's political opponents, such as Bo Xilai.[2] Several state competences were taken over by different commissions in the CCP Central Committee, with Xi Jinping presiding over most of the important ones (e.g., foreign policy, reforms, the economy). Moreover, various legal regulations were introduced with direct jurisdiction on both Chinese and foreign entities: State Security Law (2015), Counterterrorism Law (2015), Cybersecurity Law (2017), and National Intelligence Law (2017). **Those regulations supersede CAI.**

This centralisation of power entailed massive campaigns against opposition groups, including lawyers ("709" crackdown in 2015[3]), human rights activists, members of religious communities, and journalists during the COVID-19 pandemic in Wuhan,[4] along with people on

[1] More on the role of globalisation in the section on economic policy.
[2] Former member of the CCP Politburo Standing Committee, commerce minister, and Party secretary in Chongqing. In 2013, he was found guilty of corruption, sentenced to life imprisonment, and deprived of all his assets.
[3] The "709 crackdown" was a nationwide crackdown on Chinese lawyers and human rights activists, which started on 9 July 2015.
[4] During the first weeks of the COVID-19 outbreak in Wuhan, several independent journalists working in the city recorded the situation there. These included Chen Qiushi and Fang Bin. One journalist, Zhang Zhan, was found guilty of "picking quarrels and provoking trouble" and sentenced to four years in prison in December 2020.

social media and bloggers [5]. A particularly discriminatory policy was introduced in the Xinjiang region in 2014, including cultural oppression, a massive "re-education camp" system and specialised surveillance of the Uyghur minority.[6] The Chinese one-party state has authorised the use of forced labour and religious prosecution, forced sterilisation, and torture under the pretext of anti-terrorism procedures. **Such a policy, which stands in sharp contrast to the values promoted by the EU, cannot be ignored in the relationship with China, including via CAI.** Meanwhile, "social credit systems" were being developed in China regionally. The CCP's goal is to combine them to create a single nationwide system that will track and evaluate individuals' and companies' behaviour depending on their social and political activities. **However, this can also affect foreigners working and living in China as well as foreign investors and amounts to an obstacle to the implementation of investment projects.**

Along with institutional changes, propaganda campaigns were introduced to strengthen the ideological base of the Party rule and the leadership of the chairman. One of the main aspects was the superiority of what is called "Xi Jinping's Thought on Socialism with Chinese characteristics for a New Era" enshrined into the party's constitution in 2017 and the state's constitution in 2018. It presumes a global evaluation that the Western liberal order is failing, with the 2008 financial crisis the most prominent reason why. This interpretation was further broadened recently with the U.S. and EU's ineffective reaction to the COVID-19 pandemic. Since 2013, the Chinese authorities have pushed the slogans of "China's dream" and "rejuvenation of the Chinese nation", which has guided and fuelled nationalistic sentiment in society. Moreover, in 2013, the **Chinese authorities prepared the so-called Document No. 9[7], which included a list of seven values forbidden to be taught in Chinese educational facilities, including universities.**

External affairs

Under Xi, China has pushed assertive diplomacy as part of an aggressive external policy through which it has tried to readjust the international system to reflect its authoritarian values and its stronger international position. In this regard, China used threats to countries viewed as undermining principles of Chinese policy (such as Sweden, Czechia, Lithuania, Germany, and Slovakia). Moreover, the United Front[8] became more active in gathering information and enhancing contacts with foreign entities in order to disseminate the Chinese rhetoric and pursue elite capture. The diplomatic offensive was enhanced by China in international organisations (UN, ITU, WHO, Interpol) in order to include Chinese political slogans (such as support for Belt and Road Initiative – BRI - or the "community of shared future

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[5] A group of celebrity bloggers were repressed due to their critical statements published on social media about the Chinese government in 2013. These were all influential bloggers with millions of followers publishing posts critical of the authorities. Their accounts were closed, hundreds were detained, and even one arrested (charged with soliciting prostitutes).

[6] Vicky Xiuzhong Xu, D. Cave, J. Leibold, K. Munro, N. Ruser, "Uyghurs for sale", Australian Strategic Policy Institute, February 2020, https://www.aspi.org.au/report/uyghurs-sale.

[7] Document no 9 was the Communique on the current state of ideological sphere - a confidential party document issued by the General Office of the CCP in 2013.

[8] A centrally administered group of organisations and Chinese state institutions supervised under the control of the CCP.

for mankind"[9]) in their activity. China's aggressive foreign policy intensified in 2019-2020 with the introduction of the Hong Kong National Security Law in contradiction to Hong Kong's Basic Law, the Sino-British Joint Declaration and the IPPCR. In the controversies over the COVID-19 outbreak, China implemented a policy of disinformation towards, for example, the EU and sanctions vis-à-vis, for instance, Australia. **It is not clear how these developments have been reflected in the decision to conclude CAI negotiations, if at all.**

The EU's response to China's changing policy has been gradual. Both the "EU-China 2020 Agenda for Cooperation" (from 2013) and "Elements for a new EU strategy on China" (introduced in 2016) tackled these issues using a common rhetoric of engagement, though noticing the difficulties in relations with the PRC. The EU tends mainly to use the set of official dialogues, political communication, and existing dispute-solving mechanisms as instruments in response to unfair Chinese practises. They were, however, not successful. It has resulted in the strengthening of investment-screening mechanisms, for example. In the "EU-China Strategic Outlook" published in 2019, apart from being described as a strategic partner and economic competitor, China is defined as a systemic rival of the EU. When trade and investment relations with China are separated from the overall external policy relationship through a stovepipe approach on the part of the EU that weakens the EU's political leverage in relations with China.

Changes in China's Economic Policy

At the 3rd Plenum of the Central Committee of the CCP in 2013, the authorities announced further market reforms within the state capitalism model of the Chinese economy. These included, among others, increased market access for foreign companies, restructuring of state-owned enterprises (SOEs), and opening up the financial sector. In general, **the Chinese economy was supposed to be based on "market forces" and the role of the state was to be limited**. The main goal should be not a high rate of GDP growth (in period 1979-2019 more than 9% average a year[10]), but a factor of "quality"—more balanced and inclusive development, based not on exports and investments as earlier, but on consumption and innovation. Moreover, the supply-side reforms of the economy were aimed at rationalising production to make it more economically viable. China's leaders named this policy the "new normal".

The change in socio-economic policy was aimed at China achieving the status of a "moderately prosperous society" by 2021—the 100th anniversary of the establishment of the CCP. Getting there would mean a doubling of GDP per capita from 2010. The next big step is to create a "modern socialist state" by 2049 (the 100th anniversary of the founding of the PRC). The CCP has also strived to enhance the role of innovation in economic development, especially by conducting its "Made in China 2025" industrial policy, which aims to make China the world leader in such technologies as AI or robotics.

[9] The concept of "community of shared future for mankind" is presented as an alternative to the Western system and as a central element of the future stability in global international relations. It corresponds to the even more vague idea of "community" from the Confucius ideal (with adaption to the modern conditions of socialism with Chinese characteristics), a so-called "tianxia"—equality of partners in the international community, but with a central position claimed by China.

[10] In 2020 the GDP growth was 2,3%, and the target for 2021 is 6%.

At Davos, Switzerland, in 2017, Xi Jinping presented to the international community how he wanted the world to view China's understanding of globalisation. He defended free trade and warned against protectionism. However, the reality differs from announcements. **Under Xi, China has mastered the policy of using its leverage in terms of market size and trade imbalances**. Under internal legislation, it forced foreign investors to transfer technology, strongly subsidised its own companies in order to become more competitive and created regulations that protected its own market. Moreover, one of the main goals of the BRI, the hallmark of China's foreign policy in recent years, is to export Chinese overproduction, especially in the steel sector.

However, **the market reforms were only partially implemented, and in some areas even reversed, which was a result of the CCP's desire to continue to control the economy and provide social stability**. That was the case of the government's intervention in stock exchange falls in 2015-16 or limitation of investment outflows in recent years aimed at boosting economic activity in China. Since 2013, the CCP's grip on the economic decision-making process has tightened and Xi's personal role in it has increased. Other reforms, for example, in the financial sector[11] or the SOE have been facing serious hurdles. Moreover, China still conducted a policy of selective opening of its market, e.g., in financial or insurance services, while keeping strategic sectors, such as energy, education, or telecommunications, closed. **The lack of significant progress in implementing the reforms or their slow pace makes them less credible. Thus, it increases uncertainty for businesses and makes CAI's main objectives, such as reduction of investment barriers or legal protection for investors, uncertain**. Moreover, in September 2020, the CCP Central Committee called even for strengthening party control of the private sector. That raised concerns in the European Union Chamber of Commerce in China[12], among others, about how private companies, including foreign ones, may be treated in the PRC. This policy was visible recently in the case of regulatory authorities blocking the IPO of Ant Group. [13]

Economic policy, but also slowing economic growth, rising labour costs, partial retreat from globalisation, as well as trade and technology tensions with the U.S., influenced FDI inflow to China. According to World Bank data, it peaked in 2013 when it reached \$290.9 billion, but in 2019 it was almost halved, to \$155.8 billion.[14] The cumulative EU FDI flows to China in the last 20 years reached around €140 billion, and Chinese FDI in the EU is around €120 billion.[15] However, in recent years EU companies' interest in investing in China has been decreasing, in

[11] In 2020, total debt could reach 335% of GDP, according to the International Institute of Finance. See: K. Sutter, M. Sutherland, "China's Economy: Current Trends and Issues", InFocus, Congressional Research Service, 12 January 2021, https://fas.org/sgp/crs/row/IF11667.pdf.

[12] "European Chamber Stance on United Front Work in China's Private Sector", European Union Chamber of Commerce in China, 12 October 2021, https://www.europeanchamber.com.cn/en/press-releases/3291/european_chamber_stance_on_united_front_work_in_china_s_private_sector.

[13] H. Sender, "Jack Ma vs. the Party: Inside the collapse of the world's biggest IPO", Nikkei Asia, 18 November 2020, https://asia.nikkei.com/Spotlight/Most-read-in-2020/Jack-Ma-vs.-the-Party-Inside-the-collapse-of-the-world-s-biggest-IPO.

[14] "Foreign direct investment – net inflows – China", The World Bank, https://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD?locations=CN.

[15] "Key elements of the EU-China Comprehensive Agreement on Investment", European Commission, 30 December 2020, https://ec.europa.eu/commission/presscorner/detail/en/ip_20_2542.

part because of administrative barriers and changes in global value chains (GVCs), and some have even left the market, such as Carrefour.[16] To attract foreign investors, Prime Minister Li Keqiang, during the National People's Congress in May 2020, announced the continuation of market reforms, including opening up further industries to foreign investment. In that regard, a so-called "negative list" of investments was further reduced in 2020, opening up sectors such as financial services, urban planning, nuclear, and automotive. In other sectors, investors are allowed to seek exemption from the list.[17] Additionally, in August 2020, Chairman Xi reaffirmed a pledge to let markets play a decisive role in resource allocation. **However, the Chinese authorities' reaction to the economic slowdown caused by the COVID-19 pandemic, including fiscal stimulus and support for companies, can make the state's role even more significant and the introduction of market reforms that much harder.**

In the coming years, China will focus even more on its domestic market. It is at the core of its still vague strategy of "dual circulation", confirmed at the 5th Plenum of the 19th CCP Central Committee in October 2020. It consists of an internal, autonomous chain of production, distribution, and consumption that will play a dominant role in the economy.[18] This is to be supported by "international circulation", which seems to envisage **more access to the Chinese market for foreign companies that can help strengthen the Chinese economy or the state's interests, especially in the high-tech sector. It can also create more business opportunities abroad for Chinese exporters and investors, in which CAI can be useful**. "Dual circulation" will be a crucial part of the 14th five-year plan for 2021-2025. The trend of focusing more on the development of the internal market has been accelerated by the effects of the COVID-19 pandemic, linked to the fall in global trade and disruptions in GVCs. **This would intensify China's efforts to be more self-reliant, especially in the technological sector[19] (e.g., through the realisation of the "Made in China 2025" strategy), and strengthen the process of selective decoupling from the global economy.**

[16] However, much FDI flows to China through Hong Kong. See: "EU-China trade and investment relations in challenging times", Directorate General for External Policies, European Parliament, https://www.europarl.europa.eu/RegData/etudes/STUD/2020/603492/EXPO_STU(2020)603492_EN.pdf.
[17] "The 2020 Foreign Investment Negative List: Changes and Challenges", The British Chamber of Commerce in China, 30 June 2020, https://www.britishchamber.cn/en/the-2020-foreign-investment-negative-list-changes-and-challenges/.
[18] F. Tang, "China's economic strategy shift shows Xi Jinping is preparing for 'worst case scenario', analysts say", South China Morning Post, 25 May 2020, https://www.scmp.com/economy/china-economy/article/3085969/chinas-economic-strategy-shift-shows-xi-jinping-preparing.
[19] More focus on a technological sphere, including production of semiconductors, was included in the report on the work of the central government presented by Prime Minister Li Keqiang at the opening of the 4th session of the 13th National People's Congress in March 2021.

Implementation of international agreements by China

China's effectiveness in implementing international economic agreements can be analysed from two perspectives: global (concerning multilateral deals within the WTO) and bilateral, concerning mainly free trade and investment agreements with particular partners.

Multilateral agreements (WTO)

The PRC's accession to the WTO in 2001 was widely regarded as a win-win for this country and other members of the organisation. Since joining the WTO, China has been one of its most active members and the Chinese economy has become an integral link in GVCs. Yet, **China has not implemented promised structural reforms, and its mixed compliance with WTO dispute rulings challenges the organisation's underlying norms**.

In the last 30 years, China has lowered its tariffs but they still remain elevated. In 1992, China's average weighted tariff rate of 32.2% significantly surpassed the global average of 7.2%. After accession to the WTO, this rate dropped to 7.7%. Since then, however, Chinese tariffs have remained largely unchanged, averaging 4.8% between 2003 and 2018, remaining at a higher level than the average for WTO members (2.6%).

Beijing's economic policies have been a source of tensions with other WTO members. Accusations of bending market rules and WTO standards concern three main issues:

- *Illegal provision of state subsidies*. As China wants to be an export powerhouse, its government incentivises companies to sell products abroad through discounts, tax breaks, and cheap bank loans that are illegal under global trade rules.

- *Discrimination against foreign goods and suppliers*. China imposes hurdles for imported products and services (e.g., non-tariff barriers) and supports domestic manufacturing, as well as demands that foreign companies operating in China buy a certain amount of components from Chinese suppliers and enforces transfers of technology by investors.

- *Controlling global supply chains.* China favours exporting finished products. As a consequence, it implements taxes and quotas to limit other countries' access to Chinese minerals and other raw materials.

China's lack of adherence to WTO rules is manifested in several ways. It is most obvious with regard to the granting of subsidies which are illegal under WTO rules, which has been strongly criticised by the U.S., Japan, the EU and others. Between 2002 and 2020, China was involved in 66 disputes—21 times as a complainant and 45 times as a respondent[20]. Furthermore, China is still not recognised as a market economy, because it has not lived up to its promises at WTO

[20] Disputes involving China largely started after 2006 as during the first years of its membership, China was rather cautious in its actions and only got involved in five disputes.

accession, e.g., China has promised many times to join the General Procurement Agreement without ever taking that step.

China's responsiveness to the DSS ruling serves as another indicator of its compliance with international agreements. It tends to show unwillingness to comply with rulings viewed as unfavourable to its interests and refers to finding ways of demonstrating sufficient legal compliance while sidestepping the spirit of certain decisions. In one of the most widely quoted disputes in the WTO (DS413), China was found guilty of having inadequately opened its market to foreign electronic payment services by making Union Pay a monopoly supplier for the clearing of RMB-denominated payment card transactions. In 2014, China's State Council announced the opening of local market to foreign payment services. However, it was not until 2020 that foreign companies like Mastercard or Visa were finally approved by the People's Bank of China to set up bank card operations in the PRC.

China's growing economy and its harsh diplomatic stance heavily influence other WTO members. This results in reluctance among China's neighbours to participate in WTO disputes, fearing Chinese retaliatory actions. As a consequence, countries strongly relying on trade with China (such as Taiwan, South Korea) have so far refrained from filing any disputes against it.

Bilateral agreements

China treats bilateral economic relations through a political lens and handles them instrumentally. With increasing economic power, China exercises growing capacity to exert pressure on foreign governments, which can lead to violation of international agreements. Since the second half of 2020, such an attitude could be observed in China's relations with Australia and Sweden. Moreover, the opening of China's market based on the free trade agreement with Switzerland has been scant. **These examples show that implementation of CAI could face hurdles, especially when political tensions arise**.

- *Australia*

The China-Australia Free Trade Agreement (ChAFTA) has been in place since 2015. Currently, China is Australia's biggest trade partner. However, Australia acted more assertively in recent years to curb its interdependence with the PRC. It has blocked several Chinese projects on national security grounds, including purchase of S. Kidman and Co Limited, Australia's largest private landowner, in 2015 and ban Huawei's from supplying equipment to build Australia's 5G mobile network. It also became more vocal regarding China's aggressive policy in the South China Sea. Furthermore, Australia in 2020 was one of the first countries to call for an international inquiry regarding the origins of COVID-19. That led to the introduction of restrictions by China on a number of Australian products, including 107% to 200% "anti-dumping" tariffs on wine. Earlier that year, some other Australian products were also targeted, including timber, sugar, barley, lobsters, and copper ore. In December 2020, Australia launched a WTO appeal against the Chinese practises. China also has unofficially curbed imports of Australian coal. These actions violate ChAFTA, which is used instrumentally by the Chinese side. The agreement was supposed to be revised in 2020 (5 years after its adoption) but that has been suspended for political reasons.

- *Sweden*

Sweden has suffered from Chinese aggressive actions despite having a bilateral investment treaty (BIT) with that country since 1983. Since 2015, Sweden and China are in a dispute regarding the fate of Gui Minhai, a Swedish citizen detained in China due to his activities in Hong Kong that China considered illegal. In 2019, bilateral relations deteriorated after the PEN Club in Sweden gave him a freedom-of-speech award. In response, the PRC announced restrictions on economic cooperation with Sweden. In October 2020, Sweden's telecom regulator banned Chinese companies Huawei and ZTE from 5G network construction. What is more, Sweden was also the only EU state in 2020 to call on the European Commission to impose sanctions on Hong Kong policymakers after last year's crackdown on pro-democracy protests and implementation of the security law there.

China's response was twofold: legal and political. The day after the CAI agreement was announced, Huawei initiated a dispute settlement process against Sweden for banning the company from its 5G rollout. China has further announced it will "take all necessary measures" against Swedish companies, with Ericsson—trying to increase its presence on the Chinese market—being the most obvious potential target. That caused Ericsson to try to influence the decisions of Swedish government towards Huawei. China is sending a signal to all European countries that banning Chinese companies from 5G network construction will inevitably lead to retaliatory economic actions.

- *Switzerland*

Switzerland and China signed a free trade agreement (CSFTA) in 2013 after just two years of negotiations. The speed may have reflected the political support for the deal from both parties. However, it has not led to much tighter economic cooperation between the partners. According to the World Bank's WITS intensity index, the value of their mutual exchange is below their overall importance in world trade. Bilateral trade has increased since the agreement was ratified, but it has been highly volatile and dominated by a few sectors.

China's market opening to Swiss goods has been minor and implemented in areas with already low trade barriers. In sectors of greater interest for Switzerland, but also the EU, such as high value-added manufacturing and professional services, little progress has been recorded. Furthermore, some important commitments included in the CSFTA have not been met, such as the parties protecting IP rights. China's involvement in tackling this problem has been widely regarded as not satisfactory.

CAI's influence on EU-U.S. relations

Joe Biden's victory in the U.S. presidential elections was widely perceived in the EU as an opportunity to improve transatlantic relations. European leaders hope that the new president, when dealing with international problems and adversaries, will renounce Donald Trump's tendency to do it alone and be much more willing to act in concert with allies, the EU in particular. Biden's declarations during the presidential campaign were promising in this regard. Those expectations were further reinforced by the selection of members of Biden's administration responsible for foreign policy, such as Secretary of State Antony Blinken, who emphasised the importance of coalition-building in solving international problems. In the meantime, the European Commission substantiated the general declarations by coming up with a blueprint for renewed EU-U.S. cooperation that involved coordinated actions to advance common interests in relations with China.[21]

Against this background, CAI—accepted in a rush despite a strong call for re-consideration coming from across the Atlantic—**constitutes an ill-timed decision that will weaken the Union's credibility in the international arena and in relations with its partners, including the U.S. While in the past many EU states condemned Trump for his unilateral and transactional approach in foreign policy, they adopted a very similar one when it suited their interest**. The deal with China confirmed a belief held by some U.S. analysts that despite lofty rhetoric the EU would be willing to adopt a more lenient attitude towards China in exchange for economic concessions. In addition, the Union accepted an uninspiring Chinese offer, while it could arguably gain more by approaching Beijing together with like-minded countries (the U.S. in particular). Worst of all, the Union undermined Biden's position, handing him a setback just before his inauguration as president. CAI, like the Regional Comprehensive Economic Partnership (RCEP) adopted in November 2020, showed that China had the capacity to neutralise the U.S. efforts to isolate it, even among its allies. **Thus, the EU decision could dent the new American administration's conviction about the benefits of a more coalition-oriented approach towards China**.

The CAI deal has been pursued in line with many efforts by the EU and U.S. alike to persuade China to grant its economic partners more reciprocity. The advantages achieved in CAI are not an unequivocal success and the conclusion of the deal has been badly timed. Advocates point out that some of its provisions that facilitate market access for European companies and ban forced technology transfer are similar to those included in the China-U.S. "Phase One" Agreement signed in January 2020. They also point out that the "Phase One" deal was an example of "managed trade", as it included goods with a specific total value that China has to buy from the U.S., potentially harming other countries' trade.

In contrast, the concessions that the EU negotiated on transparency on state aid, for instance, could, if implemented, also benefit other countries under the Most Favoured Nation rule.[22] The decision to conclude the talks on CAI at the given moment should not be interpreted as a U-turn with regard to the EU's readiness to cooperate with the U.S. on China, but rather as **a reflection of the Union's growing aspirations to strengthen its strategic autonomy, however broadly and vaguely defined. It can be seen as an effort to enhance the EU's influence over the common transatlantic approach vis-à-vis China**. It showed that the EU, although willing to cooperate with the U.S., does not intend to simply align with the position of its ally but expects the common stance to reconcile the approaches of each side. Such ambitions—given that the EU and U.S. at times disagree on the best ways to tackle China's growing assertiveness—have to be dealt with by U.S. leaders. Some European decision-makers

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[21] "A new EU-US agenda for global change", European Commission. 2 December 2020, https://ec.europa.eu/info/files/joint-communication-new-eu-us-agenda-global-change_en.

[22] CAI is more of a traditional bilateral investment agreement following a supposedly win-win logic, whereas the "Phase One" deal is rather a specific trade deal that unilaterally imposes the U.S. demands on China and which was aimed at diminishing trade tensions between those two countries.

may have assumed that by demonstrating the EU's ability to get a deal with China, the EU would prove its worth to the U.S. as a demanding but useful ally. CAI could also be seen as a hedging approach through which the Union would benefit from the Chinese concessions even if the transatlantic cooperation on China is less successful. To foster transatlantic trust and mutual understanding, in the period leading up to ratification of the deal the EU must show that it is committed to countering Chinese actions that both the Union and the U.S. consider harmful.

Part II: Economic and legal issues

Scope of the agreement

CAI consists of a preamble and six sections: I - Objectives and general definitions; II - Investment liberalisation; III - Regulatory framework; IV - Investment and sustainable development; V - Dispute settlement; VI - Institutional and final provisions. According to the European Commission, it is the most ambitious investment agreement that China has ever concluded. There were three main goals declared by the Commission and a first assessment if that has been achieved.

- *To advance market access for European companies*. CAI will entail some market openings, even though they are limited. These are rather typical for FTAs changing tariffs between the parties or agreements like the U.S.-China "Phase One" deal, committing the side(s) to export goods. CAI must therefore be considered an agreement *sui generis*. However, CAI cannot be described as a standard investment agreement because it does include also some market-opening provisions or questions of more political nature as the issue of forced labour.

- *To create equal rights and opportunities for European businesses vis-à-vis Chinese entities.* The agreement promises to contribute to a more level playing field for European companies on the Chinese market in such areas as transparency (including in public subsidies), investor protection against technological expropriation, commercial actions of SOEs, implementation of sustainable development objectives (including the Paris Agreement), and Chinese efforts "on its own initiative" to move towards compliance with International Labour Organisation (ILO) core conventions.

- *To improve protection of EU investments in China*. CAI lacks a significant part that was initially supposed to be included in the agreement—investment protection. An efficient investor dispute-resolution mechanism is indispensable due to the dominant role of the state in the Chinese economy. However, both parties committed to pursue negotiations on investment protection and investment dispute settlement within two years of the signature of the agreement. Moreover, CAI continues to allow both sides to reject particular investments for reasons of national security or other higher interests. The agreement does not cover public procurement, as China refuses to open this sector neither bilaterally nor on the WTO level.

CAI is intended to move towards new, more balanced EU-China economic relations. China granted concessions in the industry and services with branches listed according to the SITC standard. New rules, however, reflect to a large extent the previous decision made in the framework of negotiations of other interstate agreements, introduction of WTO rules, individual contracts with companies, as well as reviews of own regulations concerning investment in special economic zones.

There is no review period foreseen in the agreement, but implementation of CAI will be monitored through an Investment Committee, which can "adopt binding interpretations of the provisions of this Agreement". The Investment Committee shall meet at least once a year and its decisions and recommendations adopted by consensus. CAI may be terminated six months after either party expresses its will to do that.

Territorial coverage

The agreement applies in full to the territories of both parties. EU territory is defined as the territories to which the Treaty on European Union and the Treaty on the Functioning of the European Union are applied. As a consequence, CAI is not applicable to overseas countries and territories belonging to some EU Member States, such as Danish Greenland or French New Caledonia. The Chinese territory is described in the agreement as the entire customs territory of China. Consequently, CAI does not cover the Hong Kong and Macao Special Administrative Regions as well as the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu, which are recognised as separate customs territories by the WTO and the majority of its members (including the EU). Such a restriction of territorial scope of application has been confirmed by China's Foreign Ministry with regard to other investment agreements. This implies that **CAI fully covers special economic zones, open coastal cities, etc., established in the territories of both parties. There are no exceptions provided in the text that could prevent EU companies from enjoying the benefits of CAI in these zones**. Such advantages to EU entities, however, will be limited due to the deficiencies of the agreement as a whole, such as the lack of an investment protection chapter.

Entities covered and potential beneficiaries

As the agreement does not open the markets unconditionally, the companies that may potentially be subject to the obligations within CAI or benefit from it vary across sectors and it depends on the market access provisions.[23] In the automotive industry the biggest companies may be considered as clear beneficiaries from the agreement as they can enjoy unrestricted access for electric cars production in new greenfield investments of $1 billion or more . These conditions are tougher to fulfil for smaller manufacturers and start-ups in the branch. What is more, the largest investors from all countries will benefit from China's commitments on services, as they will apply on the MFN basis. The agreement does not contain any specific provisions for small and medium-sized enterprises (SMEs) that could lower their entrance costs.

[23] More in the section on market access.

At the same time it is limited to local entry, and operations as cross-border services are not covered by the agreement.

However, and what is extremely important, is the coverage of the SOEs in their transparency obligations, and non-discriminatory commercial activity. A very positive outcome of the agreement is the broadened definition of an SOE that includes companies in which the state holds a significant minority share or those created by local authorities.[24]

A special group of beneficiaries of the agreement are senior managers and specialists working for Chinese companies in the EU. They can take advantage of a new regime for residency and work permits which will be granted for three years. In the area of labour, another important issue is the prohibition of employment quotas based on the nationality criterion.

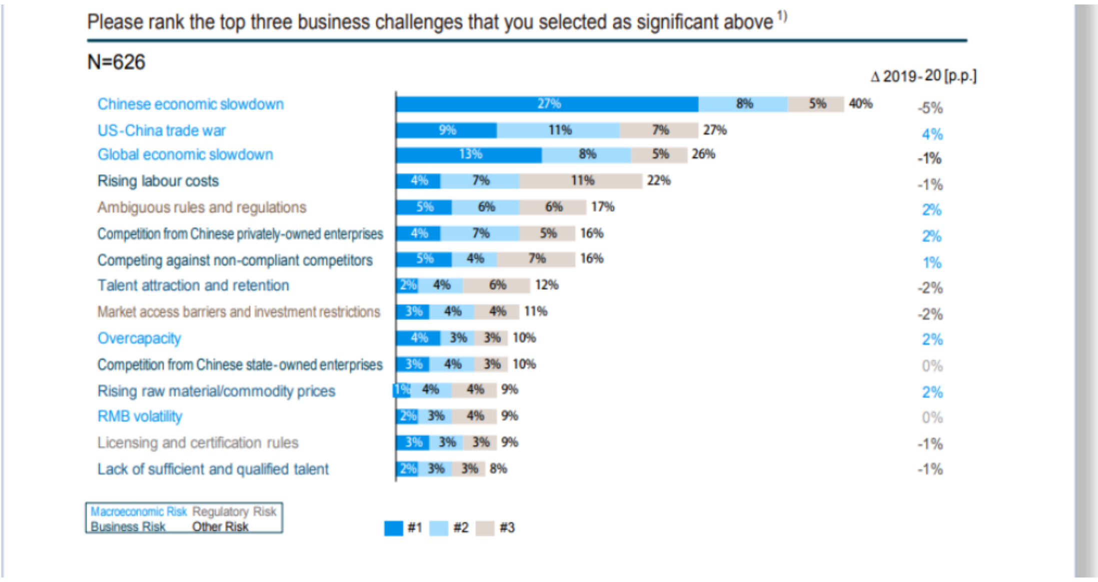
Challenges that European investors are confronted with in the Chinese market

One of the major flaws in the economic relations between China and the EU has been unequal conditions for companies planning or already running an investment. While the EU followed a liberal approach and granted wide opening of its market for investors, China applied restrictive, protectionist measures in order to protect its market and pursue its own industrial policy goals. **This asymmetry has become unsustainable over time: after decades of economic growth, rising competitiveness, and technological progress in China, there is little reason for keeping a differentiated level of openness**.

The most important source of information about the inequality of the openness and opportunities in both markets are the views of European companies. At the beginning of 2020, the EU Chamber of Commerce in China conducted a survey[25] of the top challenges for its members. Due to the COVID-19 pandemic, macroeconomic factors were mentioned most often. However, regulatory and business risks related to economic structural determinants, as well as particularity China's political system, which translates into legislation, were also high on the list. Ambiguous rules and regulations, along with market access barriers and investment restrictions, were mentioned as a challenge by, respectively, 17% and 11% of the enterprises that responded to the questionnaire.

[24] More in the section on the level playing field.
[25] "European Business in China - Business Confidence Survey 2020", European Union Chamber of Commerce in China, http://www.europeanchamber.com.cn/en/publications-business-confidence-survey

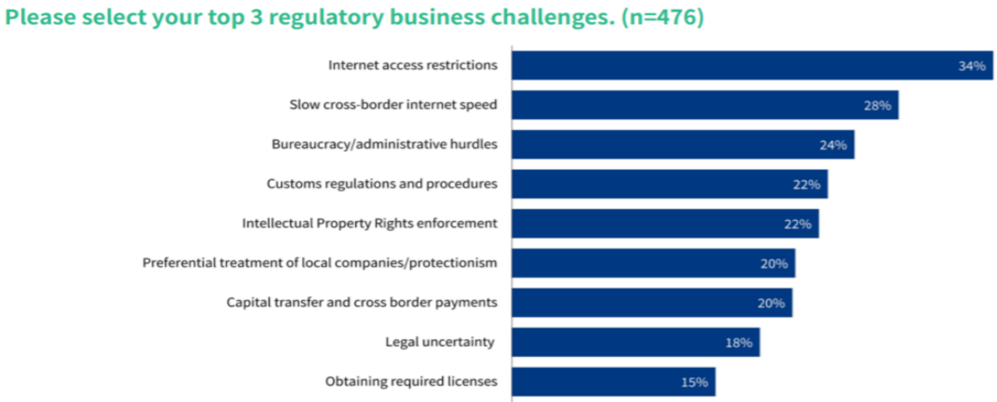
Figure 1. Key Business Challenges for EU Companies Investing in China



Source: European Business in China–Business Confidence Survey 2020.

Another survey focusing solely on regulatory challenges was conducted last year by the German Chamber of Commerce in China. As Germany is far ahead of any other EU country regarding FDIs in China, the chamber has capacities to carry out highly representative research. In particular, the issue of internet access in terms of regulatory aspects (34%) and internet speed (28%) was on top of the agenda. The top-6 list of regulatory business challenges is then followed by bureaucracy/administrative hurdles in general (24%), customs regulations and procedures (22%), and IP rights enforcement (22%), as well as preferential treatment of local companies (20%).

Figure 2. Biggest Regulatory Challenges for German Investors in China



Source: German Business in China–Business Confidence Survey 2020/21

Preliminary overview of the market access offers

Generally, China's market-access offers follow a regular scheme. They start with transactional case-by-case concessions with bilateral partners, which are later on implemented on the multinational level. **CAI does not stand out from that scheme and its reach is further limited by the lack of access to the Chinese procurement market. It mostly consists of recycled market commitments with a few new ones added in**.

What does the EU get?

- Automotive sector: 100% foreign ownership allowed in the case of a minimum $1 billion investment in new greenfield manufacturing plants for electric and hybrid cars or in provinces without excess capacity (a political criterion that enables authorities to use their discretion to decide whether to accept investment in the region). Such access was already granted in 2019 to BMW and Tesla.
- Financial services: confirmation of liberalisation that was already granted to U.S. services in the "Phase One" agreement. Ceilings for foreign ownership of securities and investment fund management companies were lifted in general in 2020. Joint venture requirements and foreign equity caps have been removed from banking, insurance, and asset management.
- Health: China has agreed to lift joint-venture requirements for private hospitals in eight key Chinese cities and Hainan Island, but the removal of the joint-venture obligation was announced in 2019.
- Cloud services: 50% cap, the same as in the "Phase One" deal with the U.S.
- Positive list of manufacturing sectors (with the exclusion of ones with significant overcapacities, such as steel and aluminium) that were already opened before, either under the WTO regime or through the successive issuance of several "negative lists" for foreign investment.
- Telecommunications: EU investments remain capped at below 50%.
- Research and Development (R&D): full market access with the exception of biological research, social sciences, and humanities.
- New market access commitments in services concern also long-term land lease, company-level market research, and digital consulting services.

More precise estimations regarding CAI's potential in terms of market access are impossible because the last impact assessment of the agreement was conducted in 2013, before the negotiations even started. The EU's and China's economies and legislation have greatly changed since then.

Opening of the abovementioned sectors mainly results from the Chinese economy's structural dysfunction (i.e., its financial and health sectors suffer from a lack of trust and institutional grounding) **and the will to tie its economic relations to the EU's biggest economies—Germany and France** (both being top health services providers). **Market access commitments will be in principle exploited by large European enterprises with sufficient technological potential in targeted sectors**, i.e., German cars account for around 20% of cars being sold in China and this number could grow further, as the deal favours already established or Chinese companies operating in the auto sector.

One of the EU's greatest wins could be binding China's liberalisation (resulting from WTO membership) in market offers and preventing it from backsliding. The EU would also be included in the case of future relaxations of existing restrictive measures, as China agreed to bind its autonomous level of liberalisation in a dynamic way.

What does China get?

The agreement has an asymmetrical nature—the European market has already been opened as a consequence of GATS commitments. The very fact that the EU remains open to Chinese investment is a win for the PRC, which is currently facing a number of economic restrictions.

Key EU sensitivities (in energy, agriculture, fisheries, and public services) have been preserved. Among the few concessions given to China is the mining and energy sector. **The agreement may open investment by Chinese companies in the production of electricity from renewables, such as solar and wind**, which, however, should be limited to 5% of the total capacities of each of the Member States and do not become dominant in the overall growth of the capacities within five years. **Power generation and grids will be excluded—ownership and operation of trading platforms in electricity will remain reserved for local companies**.

This concession plays an important role for China. As presented in Figure 3, energy (together with transport and technology) is in the top 3 of all Chinese investments, and thanks to CAI their scale might potentially grow in the following years.

Figure 3. Sectoral Share of Chinese investments in the EU Member States

Source: China Global Investment Tracker (CGIT).

Conditionality and reciprocal arrangements

The EU declares that its market access openings[26] are conditional upon China providing a comparable level of commitment. However, the text of the agreement does not mention how this conditionality will be verified. Announced market access openings could still be derailed as a result of screening legislation introduced recently both on the EU level (November 2020) and in China (December 2020). **For reasons of national security or other higher interest, each party has the right, by means of an individual decision, to block an investment**. The rules adopted by China provide for a thorough screening of each investment from the point of view of the broader Chinese national interest (Measures for Security Review of Foreign Investment issued on 19 December 2020), which may reduce the opportunities of European investments in China. The PRC still limits access to several sectors of its market perceived as strategic and important for its security, such as media or some education services. China in the past did use economic and trade dependencies to pursue its strategic goals and put pressure on partners, e.g., on South Korea imports of goods and services during spat on the U.S.'s THAAD missile system deployment in its territory in 2016-17. CAI and the new law allows the Chinese government to use new justifications to block foreign investments.

Moreover, **on 9 January 2021, the Chinese government introduced a mechanism enabling support of companies affected by sanctions imposed by other governments and prohibiting entities operating in China from compliance with such sanctions**. **These provisions may be applied to limit the liberalisation provided for in CAI. These rules actually show the philosophy of the concessions made—they will not cross the line of the economic or political interests of China, or actually the CCP**.

Reciprocity in CAI is mentioned in residency and work permits. They concern intra-corporate transfers of senior managers and specialists working for foreign investors.

<u>Level-playing field</u>

The agreement seeks to create a level-playing field in the Chinese market because without it, any market access provision may seem illusive. All aspects of this issue seem equally important for European investments.

First, both sides will be obliged to report subsidies for services (they are not covered by transparency procedures under WTO agreements). **This is intended to allow for greater transparency and ultimately to avoid such activities, which are particularly common in China**. The amount of subsidisation of companies over a three-year period allowed in CAI exceeds that allowed under the Trade and Cooperation Agreement between the EU and the UK, although it is standard compared to other EU agreements. There are two years to comply with this transparency obligation. Most important, the services sectors seem to be covered by this obligation, but they are limited to the positive list in the annex, which is going to be published

[26] In particular in computer services, telecommunications services, financial services, R&D, environmental services, legal services, international line shipping services, delivery services, manufacturing, real estate, construction, recreation, and culture.

soon. **However, the enforceability of such provisions may be in doubt**. China's current policy of reporting subsidies on WTO-regulated goods leaves much to be desired. The monitoring mechanism within this organisation is ineffective and proceedings are ongoing against China for failing to make this information available. **Therefore, it is of great concern that the potential enforcement in this context might be only of a political nature**.[27] Furthermore, the solutions to unfair subsidies on the Chinese market entail merely a consultation procedure. Possible solutions must be accepted by both parties, but are not subject to the dispute resolution procedure. **Therefore, CAI will hardly help to effectively reduce or even eliminate unfair subsidising of Chinese companies**.

Second, levelling the playing field rightly addresses the issue of state-owned enterprises. **A strength of the text of the agreement is the application of a broader definition of SOEs, involving companies where the state occupies a significant minority share or those created by local authorities**. CAI aims to ensure that there is no discrimination between domestic and foreign entities in the commercial activities of state-owned enterprises—purchase or sale of goods and services. China has also committed itself to ensuring transparency—access to information to verify the activities of SOEs. These issues are a great improvement against the current situation. **However, again, it is only the actual implementation of these provisions that will represent the success of the CAI.** These reforms would act against the philosophy of the tighter grip of the CCP over key sectors, companies and the possibility to shape the economic policy. Therefore, this provision might prove to be implemented only as far as the interests of the ruling party are satisfied. **The dispute resolution and its enforcement will be the key**.

Third, **the agreement also prohibits forced technology transfer or disclosure of sensitive information through licensing procedures**. Prohibitions in CAI also include forcing the location of a company's premises, imposing export limits, or the obligation to supply products. **These rules are even further reaching than in the "Phase One" deal**, as the usage of "indirectly" and "otherwise interfere with" in CAI's Section II. Article 3, para. 3 ("Performance requirements") might lead to fairly broad interpretations of the government actions covered. **If these commitments were to be effectively translated into laws and regulations, they would significantly help companies from sectors listed in the agreement. The key will be the willingness to implement this solution and, if China proves unwilling, the effectiveness of the dispute resolution mechanism. Its weakness is that liberalisation of these barriers might depend on the sector and technology involved**. China might just put pressure on a few companies that it regards as of key importance. In 2020, it increased expectations that companies should localise their supply chains and shift R&D and higher-value parts of their manufacturing processes to China. Companies are seeing their investments at risk if they do not comply. The prohibition of such actions might prove to be short of addressing the issue in the non-market economy.

Taking implementation of the "Phase One" deal into consideration, **China has indeed enacted several provisions implementing commitments from this agreement in 2020**. Intellectual

[27] More in the section on dispute settlement.

property can be better protected thanks to the implementation of the new Patent Law, Foreign Investment Law, or key interpretations of the Supreme People's Court. **However, IP handover was not addressed at all, which might indicate China's unwillingness to deal with the trade secrets issue**.

Fourth, China has also committed itself to increasing the predictability of regulatory procedures and giving access to standard-setting processes for EU companies. **However, law-making and compliance requirements are largely opaque in China and it is difficult to determine to what extent the provisions of the agreement can change this situation, since no reforms are expected before the agreement is ratified.**

Delivering on these level-playing-field commitments would not only require legislative changes at the top (some have been already introduced, e.g., in regard to joint ventures and investment caps, technology transfer or enhancing IP protection embraced in the Foreign Investment Law) but most of all implementation of complex regulations concerning overlapping jurisdictions on various administrative levels. It would further need to entail SOE reform in order to guarantee their competitiveness in a more open and fairly regulated market as well as deep reshuffling of the innovations system. **It would require profound changes to the top-down state capitalist system that creates incentives for opportunistic informal behaviours and nudges to breach rules**.

Coverage of the challenges

Challenge	**Description**	**How addressed in CAI?**
Internet access	As the internet in China is highly regulated, foreign websites run slow or access to them is blocked. Inadequate internet speed is an obstacle, as foreign companies often need to connect to servers that are located abroad and work with foreign digital services or platforms for daily operations.	Not addressed
Bureaucracy and administrative hurdles	China is characterised by a comparatively weak and fast-evolving judicial and regulatory institutional environment. There is great flux and little transparency in regulatory change across a broad range of spheres. Standard everyday tasks like obtaining permits and product approvals may become a drain on management resources. Local and central-level governmental actors can potentially exploit local institutional fragility and	Covered in the level-playing-field section by enhancing the transparency of the regulatory framework. However, implementation highly uncertain due to China being a non-market economy.

	regulatory flux to preferentially favour and support domestic firms.	
Intellectual property	There is little intellectual property rights protection in China. Furthermore, joint ventures schemes are obligatory in many sectors, which lead to forced technology transfer.	IPR protection enhanced by CAI even in comparison to the "Phase One" agreement. However, there is doubt about whether IP handover will be really addressed by China.
State support for SOEs	Key industries remain open only to China's SOEs at worst, or heavily distorted by state-owned players that control the majority of the market at best	CAI sets rules for the commercial activity of SOEs and for transparency of subsidies in the services sector. There are also market openings. However, these might contradict the economic interests of the CCP and be only partially implemented.

Sustainability Chapter

Another issue related to guaranteeing the level playing field concerns environmental and labour standards. The sustainability chapter of CAI includes both parties' commitments to improve environmental and labour standards with a view to attaining the objective of sustainable development, not to use them for protectionist purposes and not to lower them to encourage investments. CAI has been hailed by a number of experts as the first bilateral agreement in which China makes such commitments.

However, **a closer look** at them **demonstrates that in fact they either repeat China's existing international obligations or remain weak and non-binding. The former is particularly visible in the case of the commitment to effectively implement multilateral environmental agreements, including the UNFCCC and the Paris Agreement**. CAI only duplicates those commitments with no stricter enforcement in case of non-compliance. The Paris Agreement or the Katowice Rulebook lack such tools as well. **The latter can be observed with respect to corporate social responsibility (CSR) and labour standards.** CAI only calls on the parties to encourage businesses to voluntarily adopt relevant CSR practises, leaving the impression that it does not treat social and governance risks seriously enough. Most important, **the agreement fails to meaningfully address the issue of forced labour**, for example, of the persecuted Uyghur minority in Xinjiang region, **and the restrictions on freedom of association and the right to collective bargaining**, as Chinese law heavily restricts independent functioning of trade unions. China commits only to "make continued and sustained efforts" to pursue the ratification of two fundamental International Labour Organisation (ILO) conventions: on forced labour and abolition of forced labour. This "best endeavours" standard has already been found insufficient by an expert panel that ascertained that South Korea was failing to comply with a similar obligation to ratify some fundamental ILO conventions embedded in its FTA with the

EU. Moreover, CAI provides that each party's efforts should be carried out "on its own initiative" (unlike the EU-South Korea FTA, for example), which enables China to object to any EU interference. As regards the two other main ILO conventions, on collective bargaining and freedom of association, CAI does not explicitly mention them and only states that the parties will "consider" ratification of "other" ILO conventions. **The use of vague language and lack of any deadline make these obligations unenforceable**. If the EU genuinely wanted to induce China to improve labour standards, CAI could have included a provision that would make the agreement's entry into force conditional upon China's ratification of fundamental ILO conventions. Alternatively, the EU could at least demand changes to national laws, as happened in the case of a similar agreement concluded with Vietnam. It needs to be noted, however, that **even ratification or change of laws may be not enough if Chinese authorities do not properly enforce the regulations adopted.**

CAI provides for a special soft mechanism consisting of consultations and non-binding expert panel recommendations for sustainability-related disputes (similar to one contained in the EU-South Korea FTA). It also establishes a Working Group on Sustainable Development to meet once a year to monitor the implementation of the Sustainable Development Section and provides for regular exchange of information. While these **measures may increase transparency with respect to the Chinese efforts, they may be insufficient to induce real change**. This is evidenced by the fact that even more detailed monitoring procedures already established by the ILO and requiring annual reporting on impediments to ratification of the fundamental conventions have been unable to do it. Due to the lack of democratic control in China, the effect of increased transparency will be limited. **One also needs to be sceptical about the possibility of verification by the EU of information provided by China**, since the agreement does not include any provisions allowing, for example, sending fact-finding missions. Such measures would have to be discussed and decided upon on a case-by-case basis. **Finally, there are no safeguards, such as ones allowing for a suspension of the treaty in case of China's manifest failure of more concrete obligations, for example, concerning the fight with climate change. There is also no possibility of trade sanctions to enforce compliance**.

<u>Dispute resolution mechanism—a key measure of the potential success of CAI</u>

CAI does not provide for one dispute resolution mechanism (DSM) but two, depending on the subject-matter of the dispute: a general one (interpretation and implementation of most provisions on market access and level playing field) and one for issues falling under sustainable development (labour or environmental standards). The general mechanism consists of two steps: consultations and, in case of their failure, establishment of an arbitration panel. This solution is a standard one and similar to those present in existing bilateral treaties (BITs) between China and most EU Member States (e.g., France, Germany, the Netherlands, Poland, Spain). It also **resembles very much the WTO state-to-state dispute resolution system** (still, CAI allows parties to have recourse directly to the WTO itself if they decide not to initiate the mechanism in the agreement). Compared with the bilateral treaties, CAI's DSM is much more detailed, setting stricter time limits for each step to be taken. The rules concerning the establishment and functioning of the panel are also more detailed than those in national BITs—CAI already regulates questions usually left to be determined by investment tribunals themselves, that is, it provides for a possibility to suspend the proceedings or prescribes that the panel shall issue interim and final reports, and sets respective deadlines. However, **a loophole is the lack of any mechanism that would allow establishing a possible sub-list of panellists if China refuses to propose anyone**. The BITs usually indicate that in similar cases the respective individuals are to be appointed, for example, by the president of the International Court of Justice or the UN Secretary-General. The final report of the panel is binding between the parties and includes recommendations on how to comply with the agreement. The defending party must bring itself into compliance immediately or within a period set by the panel, and inform about the measures taken. If it fails or if the other party considers the measures insufficient, it **may suspend some of its CAI obligations to the party in violation in order to enforce compliance**. This means that, in case of continuing violations of its companies' rights by China despite the findings and recommendations of the panel report, the EU could lawfully retaliate, for example, by limiting Chinese companies' market access in respective sectors. This solution is similar to the WTO countermeasures mechanism, although the WTO agreement provides for a pre-emptive review by a panel of the measures to be taken, while in CAI the review may be sought after the suspension. **This mechanism appears to be a well-designed tool capable of inducing China to comply with its obligations but its inapplicability to subsidies limits its usefulness**. Unlike the BITs, CAI includes also the possibility of mediation in case both the EU and China agree to it. Still, the rules on it are to be developed within three years after CAI's entry into force.

The DSM on sustainable development issues largely diverges from the general one, and in a negative way. After mandatory consultations, a panel of experts may be set up (once again, no backup mechanism for the selection of candidates is provided for). The main difference between it and the arbitration panel is that **it can only make recommendations** for resolution of the dispute, so its reports are not binding. Also, **there are no measures provided to induce the other party to bring itself into compliance**, apart from the obligation to hold consultations on the measures to address the matter once again. One should notice that the WTO system does not provide for any binding procedures with respect to sustainable development issues as well and that the EU has included a similar mechanism in its agreement with South Korea. Still, **the lack of any meaningful enforcement provisions boils this mechanism down to just lip service to the issues championed by the EU**.

Finally, the general DSM embedded in CAI greatly differs from the one in the U.S-China "Phase One" agreement. In this deal, the complaining party may submit an appeal to the other party, which has to carry out an assessment of the case, and then the consultation process begins. If both do not reach consensus, the complainant may unilaterally suspend its obligations under the agreement towards the other or adopt another form of countermeasure (called "remedial measures"). There is no judicial review provided and the party that considers the action against it as taken in bad faith may only initiate withdrawal from the agreement unless a political solution is found. As seen from above, this mechanism is entirely political and because of that more prone to produce aggravation of bilateral relations than the one in CAI. However, an advantage of the "Phase One" deal's mechanism is that it makes enforcement much quicker.

Effectiveness of CAI

The level of protection of the EU against China's competitive advantage resulting from the restrictions on EU companies' market access and other unfair practises will be patchwork and vary depending on the issue in question. A number of China's commitments (e.g., on SOEs, treatment of EU investors with respect to administrative proceedings, licensing and qualification requirements, or banning of forced technology transfer), which go beyond existing WTO obligations and are similar to the concessions received by the U.S. in the "Phase One" deal, **will be judicially enforceable**. Still, it will be possible to enforce them **only through the state-to-state dispute settlement system (SSDS)** established by CAI unless a reformed ISDS or another investment protection mechanism is negotiated between the EU and China.

Importantly, **CAI postpones a solution concerning investment protection through a rendezvous clause in the agreement. This means that the EU Member States' BITs will remain applicable, maintaining different levels of protection for EU investors. The two-year deadline to finalise the investment protection section is toothless—there are no real incentives to bring the parties to the negotiating table and make them seek consensus** (e.g., a provision that the whole CAI expires if a solution on this issue is not reached). **So, in the end, CAI may fail to ensure equal protection of EU investors if China refuses to engage in meaningful negotiations**. While negotiating the investment protection chapter, the EU will probably aim to establish a reformed ISDS mechanism with an Appellate Tribunal similar to the one put in place by the CETA agreement with Canada, also leaving the possibility to replace it in the future with a Multilateral Investment Court. The EU currently promotes this as a go-to solution in all its investment-related agreements.

In the case of a number of other provisions mirroring existing obligations under the WTO law, such as the prohibition of quantitative restrictions, monopolies and quotas or the national and MFN treatment, **the EU will be able to have recourse either to the SSDS or to the WTO two-step dispute settlement system**, pursuant to the 2020 Multiparty Interim Appeal Arbitration Arrangement to which both the EU and China are parties.

However, CAI will have little effect in relation to transparency as regards subsidies to the manufacturing sector (China does not comply with WTO rules), to the detriment of the EU companies who invest in China mostly in this particular sector. **Although CAI contains provisions on service-related subsidies and these are a significant addition to the existing WTO GATS rules, it will not be possible for the EU to effectively enforce them, since CAI's dispute settlement mechanism does not cover the subsidies at all. Based solely on CAI, the EU will only be able to make use of a specific two-stage consultation mechanism, which is political and lacks genuine enforcement power**. Nonetheless, the EU will remain able to litigate the provision of subsidies having an impact on trade in goods relying on the WTO Agreement on Subsidies and Countervailing Measures (ASCM), and make use of the

WTO dispute settlement system and additional dispute settlement procedures put in place by the ASCM. In the case of services, the EU will only be able to enter consultations in accordance with GATS (a mechanism inferior even to that contained in CAI).

Finally, due to limited enforcement possibilities, the agreement will probably not be able to provide effective protection against unfair regulatory competition with respect to labour and environmental standards. Moreover, since these are so-called "WTO plus" issues, for the time being it will not be possible at all to litigate China's commitments in these fields using the WTO system. So, in effect, China may be inclined to take advantage of differences in standards in this regard for the benefit of its own companies.

Conclusions

Political

Since the launch of the CAI negotiations the international environment as well as China's domestic and foreign policies have significantly changed. The political agreement on CAI at the end of 2020 showed that China's activities in recent years have not been sufficiently taken into account by the EU. The decision to conclude the CAI negotiations amid Xi Jinping's tightening grip on the economy, violation of international law (e.g., in Hong Kong or regarding human rights in Xinjiang) and assertive or even aggressive diplomacy towards EU Member States during the COVID-19 pandemic, was politically beneficial for China. The same was seen in the undermining of a new opening in transatlantic relations in the wake of the start of Biden's presidency after Trump's turbulent tenure. Therefore, the timing of the conclusion of the agreement could be perceived as sub-optimal.

CAI focuses on only two dimensions of the EU's strategy towards China: cooperation and competition. The notion of systemic rivalry is not explicitly withdrawn, but it does not feature prominently. Greater EU leverage on China could be achieved by forging a common position with the U.S. and coordination of actions involving other like-minded countries, such as Japan. Taking the decision without consultations with its close ally and in the context of China's actions both internally and on the global stage has undermined the EU's credibility, including in terms of its promoted values and vision of international relations. The EU also runs the risk of pushing President Biden to reconsider his commitment to rely much more on allies in dealing with China. However, the decision to conclude talks on CAI cannot be interpreted as a U-turn regarding the EU's readiness to cooperate with the U.S. but rather as a reflection of the Union's growing aspirations to strengthen its strategic autonomy and, consequently, its influence over the common transatlantic approach vis-à-vis China. Even though CAI creates a more complicated context for a quick revival of EU-U.S. cooperation on China, it does not preclude it. To regain American trust, in the period leading up to ratification of the deal, the EU must show that it is committed to countering Chinese actions that both sides consider harmful.

The EU (including the EC, the Council of the European Union, European Parliament, and Member States) should seek leverage on China by insisting on ratification of ILO core conventions as a prerequisite for ratification of CAI. In the case of Vietnam, the EU additionally demanded changes to national labour laws.

In parallel, the EU needs to put in place—before a decision on ratification of CAI—adequate autonomous instruments to defend its interests vis-à-vis China where CAI is too weak. Such instruments would pertain not only to China but also to other countries. This should include the international procurement instrument; a ban on the import of products of forced labour into the EU market; human rights due diligence legislation; measures against unfair subsidies on the basis of the EU's white paper of June 2020; the "bazooka" against economic coercion; and an enhanced investment screening mechanism. The EU may also develop mechanisms such as the Strategic Investment Facility that support relocation of strategic goods (e.g., in the health sector) from China.

CAI does create an institutional basis for political consultation between the parties. It remains to be seen to what degree that could be an efficient way to discuss issues hampering European investment in China. The regular high-level consultations between the respective authorities may prove beneficial for EU companies' interests if there is enough goodwill on China's side and are not marred by prolonged discussions. It is hard to see, however, how far this mechanism could be effective in dealing with a multitude of issues in a various sectors.

Economic and legal

A full economic impact assessment of CAI will be possible only after it becomes clear to what extent Beijing is implementing its provisions. China has often failed to comply with international agreements when they were not in line with its political or economic interests. For example, in the "Economic and Trade Agreement Between the United States of America and the People's Republic Of China: Phase One", China committed to purchase no less than an additional $63.9 billion of covered goods from the United States by the end of 2020 relative to 2017 baselines. China's trade with the U.S. failed to meet the deal's targets last year, partly a result of the economic crisis caused by the COVID-19 pandemic. Data from the U.S. Census Bureau (U.S. export data) and Chinese customs (China's import data) shows, that in the first year of the agreement China's purchases only reached 59% (U.S. exports) or 58% (Chinese imports) of the target.[28]

CAI mostly consists of recycled market commitments with a few new ones added in. Market access concessions can be recorded for the automotive industry, in telecommunications, digital and cloud services, business services (like estate services, market research, translation), and also health services. Companies from the EU will be allowed to own health clinics in eight large cities and enter the quickly rising branch of human health services. Areas in which restrictions remain are connected with research in biotech. Among the measures restricting economic freedom are usually ownership caps. However, China's regulations concerning internal

[28] C. Bown, "US-China phase one tracker: China's purchases of US goods", Peterson Institute for International Economics, 8 February 2021, https://www.piie.com/research/piie-charts/us-china-phase-one-tracker-chinas-purchases-us-goods

security, such as the State Security Law or Counterterrorism Law, which are not affected by CAI, or the implementation of the nationwide social credit system can hamper EU companies' investment activities. Moreover, on the wide interpretation of national security reasons, practically every EU company's investment can be blocked.

China's market access commitments will be in principle exploited by the largest European enterprises with sufficient technological potential in targeted sectors. These provisions could, however, create lock-in effects for companies from selected sectors (especially automotive). As entry costs are high (both in terms of the financial requirements or legislative barriers mentioned by EU investors) and economic gains substantial, companies agree to be an important part of China's economic ecosystem with all its consequences. They might operate in China according to the political logic set by the CCP and be more responsive to political than economic nudges. Examples of such behaviour could be seen recently, such as when the CEO of Ericsson, which is trying to boost its economic activity in China, tried to convince the Swedish trade minister to abolish the ban on Huawei's participation in Sweden's 5G rollout.

This is the single most significant part of the assessment of the agreement—whether China can be trusted to really adjust to the legal framework of CAI. If the legal framework remains only on paper and pressure will be put by authorities on individual companies that invested hugely in China, CAI will serve only the interests of China, not the European Union. Investment protection is another interesting case. Even large transnational companies could be afraid to sue China under ISDS provisions (if they are added to the agreement) as they fear prospective blocking of their access to the Chinese market. In that way it is not the EU that would be the standard-setter for global companies by attracting investments and giving access to its consumer market—CAI might indirectly help China become one.