Asia Power Watch
an observatory of Asia-Pacific economic power

The future of EU – China investment cooperation

by Miljan Radunovic

Introduction

It is not that Europe and the US were unaware of China's development throughout the 20th century. Riding the tidal wave of post-World War II optimism, and yet drawing political ideology lines on where recovery funding of the Marshall Fund will be allocated in Europe, both the US and Western European countries did engage with China in political, economic and other relevant aspects. This is why being surprised by China's progress in the past decades can only come as a surprise to those who tend to plan on short and midterm level.

In addition to this, waking up in 2020 to China running neck and neck with the US and eying Europe as its main export destination could be, to some extent, attributed to the underestimating the potential of such a unique demography and distinctive national motivation rooted in collective memory dating centuries ago. One should not exclude a set of international circumstances spanning from politics (cold war), science development (introduction of semiconductors), technology progress (3rd and 4th industrial revolution), trade expansion (globalization of supply chains) and last but not least global health (Covid-19 pandemic).

In order to know where we are headed, while acknowledging the "*new post-Covid-19 reality*", one should look back and see how we got where we are now, and what can be learned from the past in order to ensure a sustainable and peaceful future. Although there is a wide array of mutually intertwined parameters that will shape the upcoming years and the relationship between China and Europe on the economic and political field, some crucial things that will most significantly contribute to the outcomes can be outlined. Understanding them individually, and how they affect each other, as well as how they will embed themselves in the existing timeline of the European and Chinese relationship, will make it easier to understand what lies ahead. The three key issues discussed here are China's 14th five-year plan, the adoption of the Regional Comprehensive Economic Partnership (RCEP) and the European Union's Foreign Direct Investment screening mechanism.

China's 14th Five-Year Plan

China's 14th Five-Year Plan (FYP), focusing on the 2021-2025 period, is probably the most impactful global strategic document to be unveiled in 2021. Though the final document will be presented in March 2021, some indications and blueprints are already available. The communique from the 5th Plenum of the Chinese Communist Party (CCP)'s 19th Central Committee, held in October 2020, sheds some light on the course and targets of the document. China stayed true to its initial goals of primarily focusing on its own well-being improvement, despite different international interpretations and opinions.

Being aware of still huge disproportion in the level of quality of life between its coastal – eastern, and landlocked – western parts, China focuses on improving its internal economy as its top priority. Avoiding the "*middle-income trap*" on a national level, working on the "*dual circulation*" self-sustainability model as well as improving the average GDP remains the ultimate goal in the economy sphere. Things get more blurry when one tries to distinguish the means from the end, given the complexity of the planning.

However, the good thing about anticipating the outcomes of the upcoming Five-Year Plan is the fact that it is likely to present an action agenda, a sophisticated yet prone to adaptations roadmap, on how to achieve certain national goals which have already been publicly proclaimed by the highest officials of state – namely most frequently President Xi Jinping. What is already known and what will only be reaffirmed and elaborated in detail, come March 2021, is that China wants to go carbon-neutral by 2060, to champion the environment protection and green-economy

industry in the manufacturing and vendors market, to continue its quest to make the yuan an alternative international currency, and focus on investing in its own research and development in the area of semiconductors, telecommunications, big data, and artificial intelligence.

If one wants to dive deeper into the "what" and "how" of the 14th FYP, it would be advisable to take a couple of steps (years) back and compare outputs of the 5th plenum held in 2015 with the 13th FYP statements and then contrast it to present state of China's role in global market. Once this is done, going through the most recent 5th Plenum conclusions (from October 2020) and comparing them to what is known with the 14th FYP can showcase what we can expect to see in March and what we will be looking at in years to come. A comparison of the 2015's 5th Plenum conclusions and the 13th FYP presented in 2016, as well as the conclusions of the 2020's 5th Plenum conclusions and the anticipated structure of the 14th FYP is provided in the Table 1 below.

5th Plenum (2015)	**13th Five-year plan (2016)**	**5th Plenum (2020)**	**14th Five-year plan (2021) – assumptions**
		2035 long term goal of achieving socialist modernization	
Moderately prosperous society, maintaining a medium-high economic growth rate, doubling 2010 GDP by 2020	Part 1: Guiding Thinking and Development Philosophy	14 FYP guiding ideology and principles	Part 1: Guiding ideology and development philosophy
13 FYP objectives		14 FYP Economic and social development goals	
Innovation as center of national development	Part 2: Innovation driven development	Sci-tech innovation and indigenous innovation	Part 2: Innovation and domestic R&D
New Systems: Spatial Planning, Internet structure, Big Data	Part3: New systems development	Modern industrial system and manufacturing power	Part 3: Modern industrial and manufacturing power
Agricultural modernization	Part 4: Agricultural modernization	Domestic market, demand and consumption development	Part 4: Dual circulation economy and domestic demand
New Individual Systems, Develop Manufacturing power	Part 5: Optimized modern industrial systems	Market reforms	Part 5:
Market reforms	Part 6: Cyber economy	Rural revitalization	Part 6: Rural revitalization
	Part 7: Modern New Infrastructure	New urbanization and regional spatial planning	Part 7: New urbanization
Urban – rural development integration	Part 8: New urbanization		Part 8: Regional coordination and spatial planning
Regionally coordinated development	Part 9: Development coordinated between regions	Cultural soft power	Part 9: Cultural industries development and soft power
Ecological civilization	Part 10: Ecosystems and the environment	Ecological civilization	Part 10: Ecosystems and the environment
Open development and opening to global economy	Part 11: All-around opening up	New style international cooperation	Part 11: New Style international cooperation

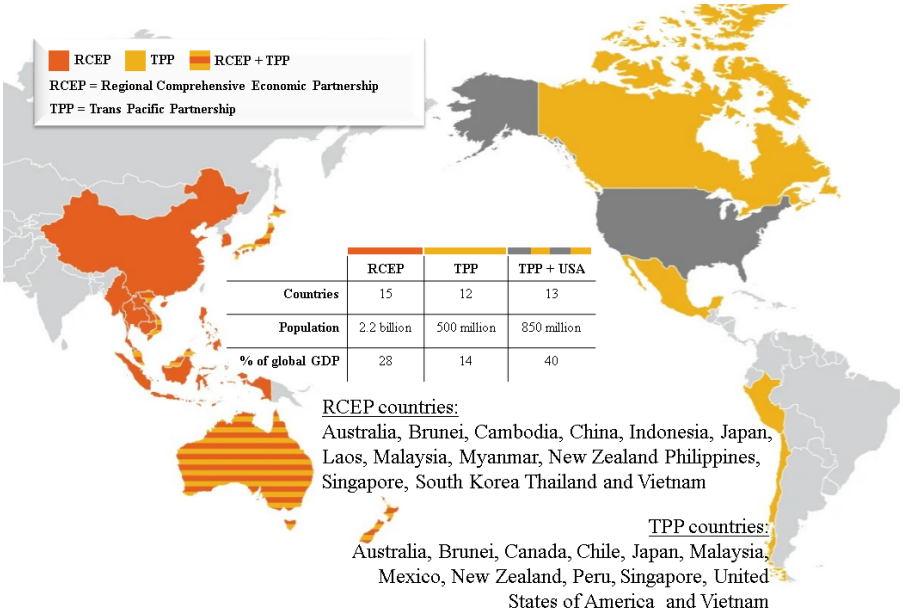
Mainland-Hong Kong-Macao integration	Part 12: Deeper cooperation Mainland, Hong Kong and Macao			Part 12:
Public Service provision	Part 13: Fight against poverty			Part 13:
Education	Part 14: Better education and health for all citizens		Human services and development	Part 14: Human services in education and health
Healthcare reform				Part 15: Human services in employment, ageing and pensions
Income inequality	Part 15: Support public wellbeing			Part 16:
Social security				Part 17:
Pension funds				Part 18:
Equalize development across population			National security	Part 19: New style national security
	Part 16: Socialist culture and ethical progress		Defence modernization	Part 20: Defence forces modernization
Party committees and party ideology	Part 17: Better and more innovative social governance			
Rule of law methods	Part 18: Socialist democracy and rule of law			
National security	Part 19: Coordinated economic and defence development			

Table 1. Comparison of 2016 and 2021 FYPs with preceding 5th Plenum meetings (of 2015 and 2020)

Once viewed in this "out of the box" long term planning perception, one could see that China does plan, as does the European Union with its European budget(s). The difference of holding elections for the European Parliament which is to implement the plan and manage the allocated budget, compared to holding a plenum of the Chinese Communist Party with almost as many members as the European Parliament itself and making decisions there, is merely a political system's difference. Also, this perception shows to what extent are things such as Belt and Road Initiative, 17+1 Initiative and massive opening up Chinese cultural centres merely paws and bargaining chips in a much bigger global game.

Signing of the Regional Comprehensive Economic Partnership (RCEP)

The November 2020 annual summit of the 10-nation Association of Southeast Asian Nations (ASEAN) held online was marked by the signing of the world's biggest trade pact. A total of 15 Asian countries signed the Regional Comprehensive Economic Partnership (RCEP) – a long awaited agreement of putting aside their differences and trying to act as a common market for their common benefit.



	RCEP	TPP	TPP + USA
Countries	15	12	13
Population	2.2 billion	500 million	850 million
% of global GDP	28	14	40

Figure 1. RCEP countries, TPP countries and general statistics (Source: adaptation of GZERO)

Back in 2015 a similar endeavour, named Trans-Pacific Partnership (TPP), led by the US, was on the brink of implementation, but was abandoned by the new White House administration in early 2017. Looking at it with a 2021 perspective, time and performance figures will show whether that was a smart thing to do for the US. Figure 1 lists the TPP countries and compares some key economic market parameters between the two alliances. RCEP however might prove to be a good test for the eternal dilemma of "*should you give the market what it wants or what it needs?*".

Without a doubt, China tailored RCEP to its long-term goals, with this 2.2 billion people market (compared to 446 millions in the EU) not being to inclined to strict regulatory frameworks and sensitive on issues such as labour rights, rule of law, transparency in procurement, environment protection or intellectual property, as was the case in Europe. Also, as presented on the timeline of Figure 2, this is one of many – a very important one though – milestones of the ongoing strategy of China to interlink itself using free trade agreements (FTAs) whenever and wherever possible.

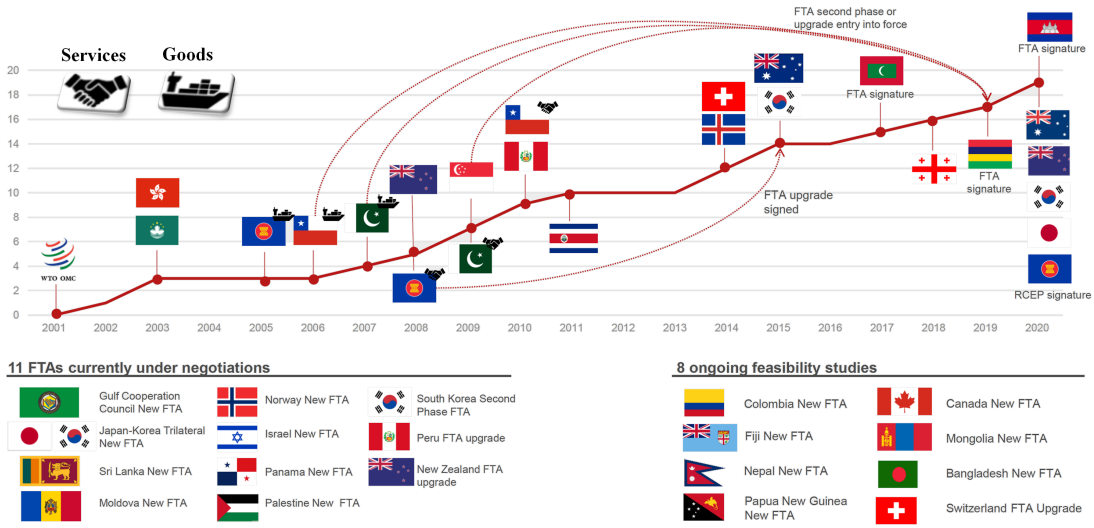


Figure 2. China's FTAs signings since entering WTO (Source: adaptation of Sinolytics)

Since joining the World Trade Organization (WTO) in 2001, China signed 18 FTAs including the most recent RCEP, and more are likely on the way. This is an agenda China will pursue in the future, and it seems that China's assumption of FTAs not being considerably affected by global disruptions might just be well in place – as it was intentionally purposefully nested somewhere in the previous FYP of 2016.

Foreign Direct Investments (FDI) screening mechanism

China must be credited for being patient, persistent and pragmatic in its approaches to investments in Europe. In viewing the Chinese long term development strategy, it is no secret that its ultimate targeted market is the one of Western Europe, and the EU is well aware of this. Everything else however is a dynamic and constantly changing variable in this equation, i.e. EU accession process in one direction and *Brexit* in the other. Hence, ways of achieving the ultimate goal are prone to adaptations, changes and sometimes innovative simplification – not necessarily always with a desired positive outcome.

Even before 2020 and the Covid-19 pandemic, number were clear that China and Europe are mutually interdependent and, unlike the case with the US – a decoupling would not benefit either party. Europe deeply relies on Chinese imports for the sound operations of its electronics, chemical and pharmaceutical industries for starters. The fact that what is imported to Europe from China is located in the less sophisticated segment of the product supply chain, does not diminish its importance and nor dependency. As a very detailed study from MERICS Institute showed in Figure 3, there is 560 billion EUR trade volume worth of business at stake therefore it is natural for both sides to work closely and diligently on precise policy definition that will foster future stability and sustainability of this trade volume.

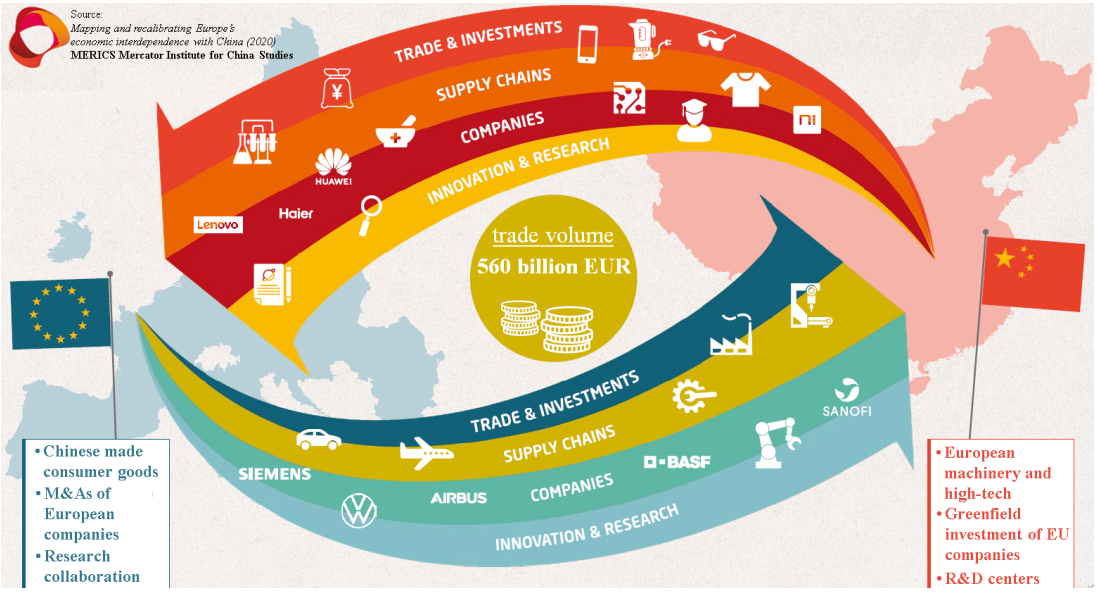


Figure 3. Trade volume and structure between EU and China (Source: adaptation of MERICS, 2020)

When presenting the European Union's long awaited foreign direct investment (FDI) mechanism in late fall 2020, Executive Vice-President Valdis Dombrovskis stated that *"the EU is and will remain open to foreign investment. But this openness is not unconditional"*. The FDI screening mechanism is a legal policy framework that provides an indicative list of parameters to assist EU member states in determining whether an investment is likely to affect its (member state's or the EU as a whole) security or public order.

According to the FDI screening mechanism, an investment can affect:

- access to sensitive information or the ability to control information
- critical infrastructure
- critical technologies
- freedom and pluralism of the media
- supply of critical inputs, such as energy or raw materials

A simplified activity diagram of how the FDI screening mechanism works is provided on Figure 4.

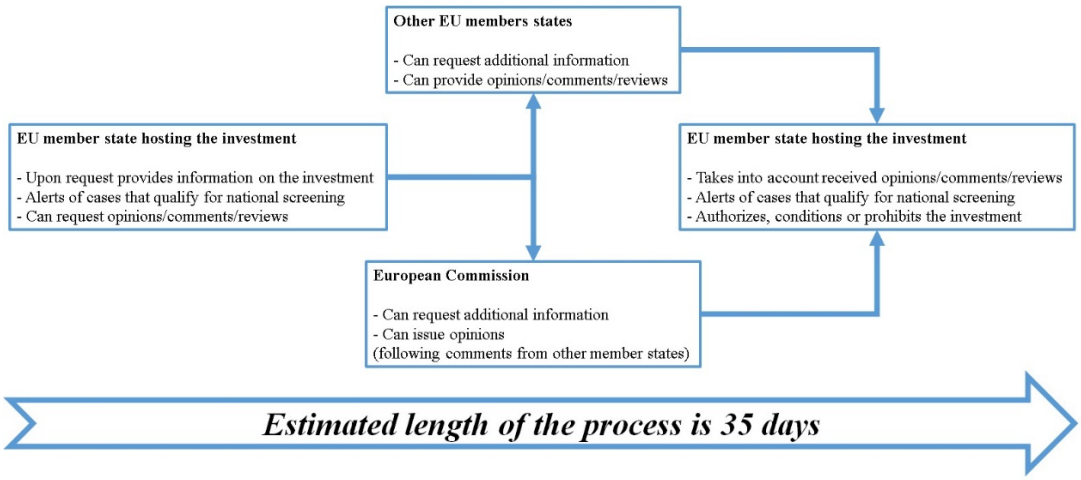


Figure 4. Process of FDI screening

The information and data which are exchanged between the host state and other EU members mainly concern:

- Sectors and locations in which they do business
- Target company and investor company
- Timeline of the transaction
- Value of the investment and the origin of the funding

Being careful not to jeopardize what it perceives important and for what it has already allocated its taxpayer's money, the EU made the FDI screening mechanism very protective when it comes to its institutionally funded programs concerning research, science and development. This is why red flags will be flashing whenever non-EU countries approach with investments that have anything directly or indirectly to do with European Defence Industrial Development, Trans – European Networks, Horizon 2020 or Galileo program. As expected, this list is to be amended and updated on regular basis – but available through for everyone to see.

However, as with every complex document that serves as a prevention to potential problem that nobody wants to occur, the tricks are in the fine prints. The FDI screening mechanism also states that both EU member states and the EU (through its bodies) can assess:

- if an investor is under the direct or indirect influence of a third country government
- if an investor had previously been engaged in public order and/or security jeopardizing activities
- if there is a serious risk of the investor engaging in criminal or illegal activities

Those prone to misinterpretation, along with wishful thinkers of constant international spats and disputes, regardless whether they are from Brussels or Beijing, would argue that the introduction of this kind of a protectionist institutional framework is merely a retaliation of some sort to China in specific, in the light of the Covid-19 pandemic.

This is wrong. A simple lookup of the history of this process will debunk this as, even before Covid-19, the FDI screening mechanism was set to take place in late fall of 2020. The simplified timeline of the origin of the FDI screening mechanism is as follows:

- September 2017: European Commission published a proposal for a legal regulatory framework for the screening of FDI inflows into the EU
- May 2018: European Parliament adopted its report
- November 2018: First draft of the document was prepared, presented and agreement was reached
- February 2019: European Parliament adopted the text by 500 votes to 49, with 56 abstentions
- March 2019: European Council formally endorsed the adopted text. The framework entered into force in April 2019, with the intention of being fully applied as of November 2020
- April 2019: FDI screening mechanism entered into force, pending approval of EU member states' parliaments
- November 2020: FDI screening mechanism is fully applied

Still more work needs to be done on national levels. The FDI screening mechanism provides requirement and conditions for national screening mechanisms which will be focusing on:

- Confidentiality of exchanged information, data and intelligence
- Measures of identifying and preventing third-party bypassing by foreign investors
- Probability of resource against screening decisions
- Transparency of procedures and rules

Naturally, the European Union will be publishing annual reports on the FDI screening mechanism implementation, hence the 2021 and 2022 ones will be interesting to read. Also, the EU is open to international cooperation with third countries on policies and practices related to investment screening so knowing the rules will definitely come in handy to those who want to play the game at least in the EU home court.

Investing or infesting – do you like the team or do you like the game?

China has been investing overseas for some time and this naturally attracted analytical attention on a global level. With an unprecedented rollout of capital infrastructure investments on a global level in the past 20 years, it comes as no surprise that some might develop a certain level of distrust towards their intentions. Different impressions though can be developed when looking at a certain thing one way. For example, if one were to observe Figure 5 showing the map of thematically categorized infrastructure investment projects led by China, as developed by Center for Strategic and International Studies (CSIS) and their Reconnection Asia section, one would have no fears for the future of infrastructure development of the Eurasian continent.

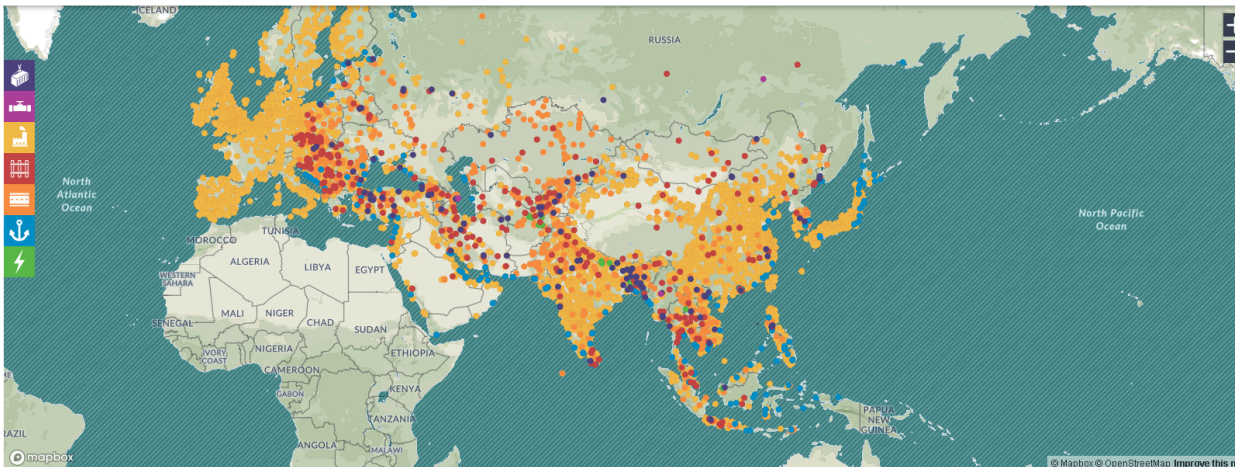


Figure 5. Past and present Chinese investments (Source: https://reconnectingasia.csis.org/map/)

Furthermore, merely glancing at the map of "*How Chinese Financing is Fuelling Megaprojects Around the World*" featured on Figure 6, a European fearing for China's influence in its backyard would feel relieved – unless living in south-eastern Europe.

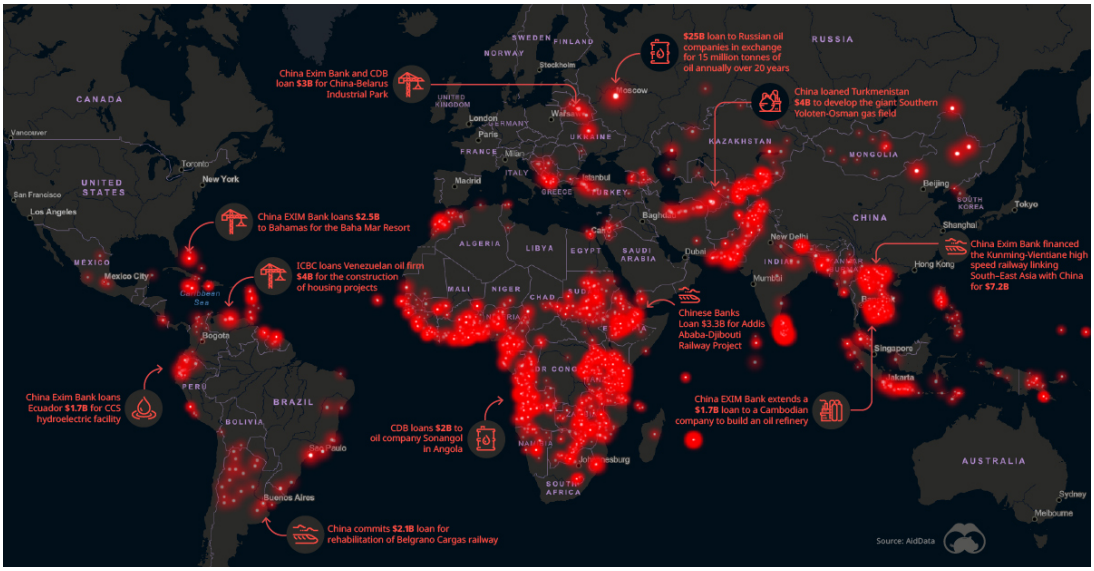


Figure 6. Chinese financing of infrastructure projects; Source: Visual Capitalist

On the other hand, if one takes a look at a very detailed map of categorized Chinese investments ongoing in Europe, beautifully depicted by Datenna from the Netherlands on Figure 7, a clear impression would be that the EU has succumbed to the financial influence of the Asian dragon.

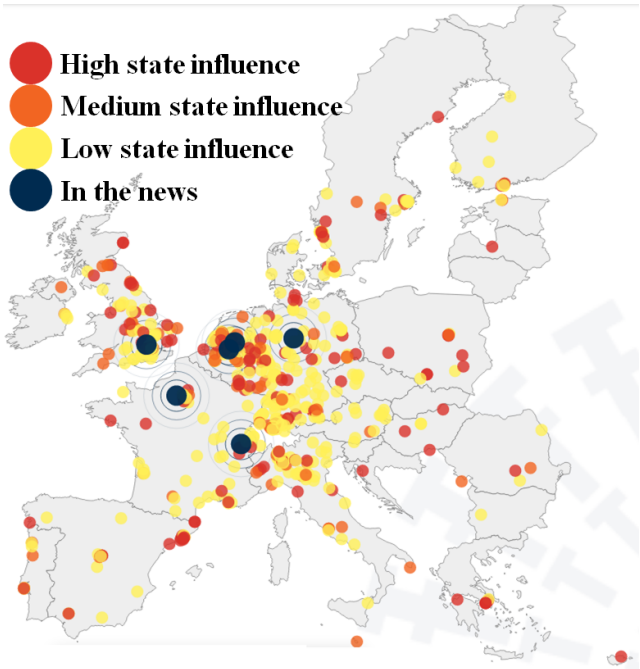


Figure 7. EU-FDI radar map (Source: Datenna, available at https://visuals.datenna.com/china-eu-fdi-radar)

If all above would be followed by a map of Chinese Confucius cultural centres opening up in central-eastern and south-eastern Europe (CEE/SEE), as shown in Figure 8, diligently composed by CHOICE's policy paper "*Empty shell no more: China's growing footprint in Central and Eastern Europe*", one might truly feel threatened.

Figure 8. Map of Confucius cultural centres in CEE/SEE

Though pictures tend to speak louder than words, numbers are key to drawing proper conclusion, and the thing with numbers is that they hardly lie. This is why exacerbated threats of China conquering Europe, along with constant taunting of its *debt traps* looming over Europe, can easily be refuted and debunked by a relatively quick analytical assessment.

As for the *debt trap* issue, despite it being a very appealing notion commonly used to portrait China, and its Belt and Road Initiative in particular, as a global conquering tool, it lacks solid factual ground. The issue generally revolves around the single case of the Hambantota port in Sri Lanka. In this case, the Sri Lankan government defaulted on a 1.3 billion EUR project and renegotiated a signing for a 99-year lease of the port itself with China Harbor Engineering Company.

Such examples of "land acquisition" tuned out not to be very frequent though. On the other hand, China did sign the Debt Service Suspension Initiative (DSSI) under the G20 framework, including its extension to June 2021. With its 1.7 billion EUR participation, it is by far the biggest creditor of the estimated 5.7 billion EUR of total credit loans allocations to the 46 affected countries. Another contributing example of downplaying the Chinese *debt trap*

conquering strategy can be seen in the cancellation of the circa 10 billion EUR project of constructing the Melaka Gateway port in Malaysia.

When talking about Europe, there is a number of parameters according to which things could be analysed. Two of those would be:

- Political – analysing the EU and non-EU (candidate members) and presence of Chinese companies in these markets.
- Type of investment – mapping mergers and acquisitions (M&As) on one hand and comparing to credit/loan-based capital infrastructure investment projects, mainly coming down to EPC (engineering, procurement and construction) contracts implemented through China Development Bank (CDB) and EXIM Bank with state-backed clients (governments or state/public enterprises).

The story behind a huge number of dots and red flags on world maps showing Chinese investments, that later get cancelled, shows how fragile, inconsistent, superficial and unreliable planning has been conducted from the side of the investor – compared to the understanding and past business practice of European market. Specifically, Chinese companies, mainly SOEs, sign dozens of Memorandums of Understanding (MOUs) with other parties – mainly public enterprises (cases of coal fired thermal power plants in Southeastern Europe where national power companies are the other contracting party), or the state itself (cases of highways in Southeastern Europe).

The key problem is that Chinese SOEs have been signing so many MOUs in the past years, that they have essentially devalued the notion and purpose of an MOU as it is viewed from the EU/US perspective (both academic and business one). MOUs do have a preliminary estimated budget, but the Chinese ones are typically accompanied by a "*legally not binding*" provision. This results in the problem of reliability of the project if one would tend to see an MOU as a confirmation that a project has commenced, and thus put in on certain map of projects.

This is closely tied with the contract transparency issue – also something constantly scrutinized by the international community. Chinese companies (again, this mainly refers to SOEs engaged in CDB or EXIM Bank EPC projects) tend to keep everything "under the hood". When it comes to contracts, this means that they do not apply standard transparency practices usually present in EU negotiations practice. They effectively act as if it were a B2B (business-to-business) and not a G2G (government-to-government) deal.

Under normal circumstances, when inking a highway, power plant or water treatment facility construction contract with the European Investment Bank, the World Bank or the European Bank for Reconstruction and Development, the total budget of the project is known. You might not know how much the Lead Project Manager is paid – but there is no need for you to know that. However, the total amount is always disclosed.

Moreover, Chinese EPC companies have a very bad history of changing (raising) the final budget of the project as the project progresses. This leads to the final problem: amendments of signed contracts. In many cases – and this is the core of the problem with doing business with Chinese SOEs and not conducting proper supervision during the investment lifecycle – they simply underperform. And then they are required to redo something or fix it. The problem – going back to the very beginning of the project and how all parties agreed to do the work – is that the Chinese side additionally charges for the fixing of what was done wrong.

But in all fairness, both parties knew what they were signing and indeed signed it. The fact that one side – and this is not the Chinese one – is less responsible for the money it operates with is a problem of its own.

Rhodium Institute and MERICS April 2020 report findings, even not accounting for the impact of Covid-19, can give very accurate baseline assessment. As shown on Figure 9, it indicates a steep decrease in state-owned enterprises' (SOEs) investments in Europe all the way from 2017. One could conclude that both the European market developed resilience for unprepared credit loan backed constructions of outdated industry facilities managed by Chinese state companies, while they themselves faced a backlash from their headquarters for not performing as desired initially.

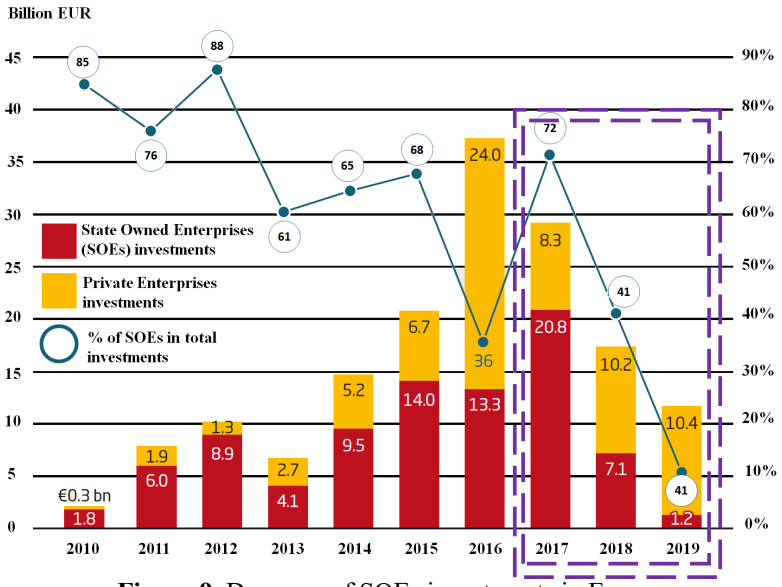


Figure 9. Decrease of SOEs investments in Europe
(Source: Rhodium Group / MERICS)

On the other hand, Figure 10, from the same report, outlines the inflow of capital through M&As into most developed countries of the EU for the 2000-2019 period. This shows a very encouraging feature Europe should be well aware of: most of the Chinese direct capital investments went to Western Europe and in those markets with stable democracies, rule of law and appreciation of European values, giving a Eurasian meaning to the phase "*money talks*".

Cumulative value of Chinese FDI transactions in EU [2000 - 2019]

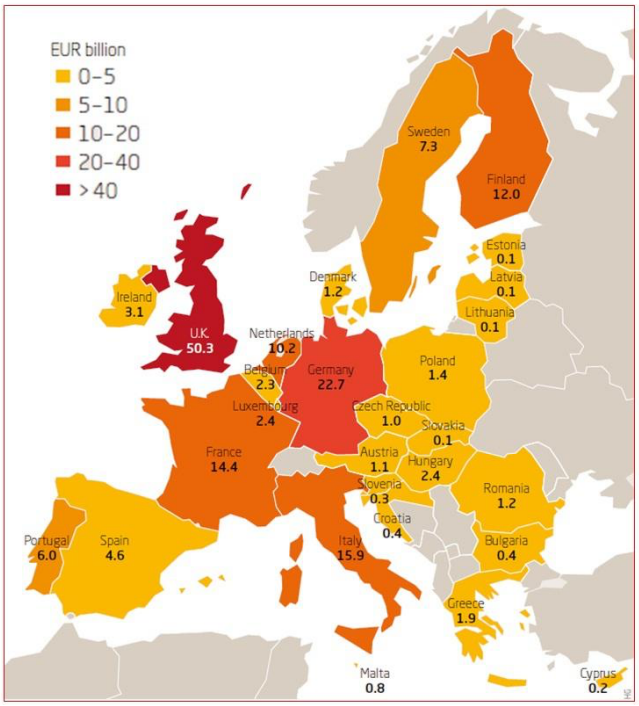


Figure 10. – Cummulative value of chinese investments for period 2000-2019 (Source: Rhodium Group / MERICS)

It is not the quantity and scale-up game that China can lose, it is the quality and performance one. Which is why performance issues and quality assessment was not an issue when developing capital infrastructure investments in Latin America, Africa and Indonesia, but turned out to be a major hurdle when trying to do the same in Europe. Building highways in Africa is different from building highways in Europe, as was seen in Poland with the case of COVEC consortium withdrawal in 2009/2011, or with the ongoing construction of a 129 km highway for 1.69 billion euros in Montenegro. The difference is that in European countries, both in the EU and EU candidate countries, the investment and overall society feature a stricter regulatory framework and public scrutiny for underperforming.

Conclusions – What we'll be looking at in 2021 and beyond

"The night is darkest before the dawn" proved to be right when it comes to fall 2020. In literary the final 48 hours of the year 2020, the EU and China made an important breakthrough in their process of agreeing on a Comprehensive Agreement on Investment (CAI), which entered into negotiations back in 2013. On December 30, on an online meeting (Figure 11), much alike the RCEP signing one in November, highest representatives of China and the EU agreed on the key elements of the CAI.

This comes as both a great relief and encouragement, proving that joint planning ahead is far from impossible. As outlined in the European Commission's press release, the CAI will be a commonly agreed legal framework – first of its kind and scope – to define obligations for Chinese SOEs, ensuring comprehensive transparency rules for subsidies and commitments related to sustainable development, while at the same time ensuring that EU investors achieve better access to a fast growing 1.4 billion consumer market, and are able to compete on a levelled playing field in China.

As for 2021, the first important checkpoint in 2021 will be the first week of November and the venue will be Glasgow, Scotland. There, the United Nations Climate Change Conference, also known as COP26, will take place, as it was delayed in 2020 due to Covid-19, as the 5th (will turn out to be 6th) anniversary of the Paris Climate Accord. Going back to the smallest common denominator of China and the EU – this being curbing the greenhouse gases by a certain date in the upcoming decades – it will be important to see what course will be taken by key stakeholders – the EU, China and the US. Once the goal (the "what") has been identified and agreed upon, the means (the "how") can vary as they are affected by a number of parameters. However, as long as the means do not jeopardize the goal, main worries will be concern business competition, competing in research and development and investing in science – less politics and more concrete results.

It is safe to expect that China will remain primarily self-centred with respect to its state-owned enterprises (SOEs), who are trailblazers of the capital infrastructure investments endeavours in Europe, regardless whether they are seen as a part of the Belt and Road Initiative or as a result of the 17+1 platform. Those thinking that China will be restraining its SOEs in their overseas investment quests should rethink their stand. Its leading credit rating agencies maintained AAA scores for its leading SOEs despite their underperforming and a wave of defaults accumulating to an almost 4 trillion EUR debt.

Europe however will not be sitting on its hands though. It will trying to consolidate its ranks and, while still treating China as a friendly competitor and a side with whom one can work with, will in its own backyard try to make up for what has been lost in the previous decade when it comes to research and development of sophisticated technology. Recent acquisition of the Piattaforma Logistica Trieste (PLT) in Italy by Hamburger Hafen und Logistik (HHLA) of Germany is an indicator of this. Also, a recently signed agreement that foresees the allocation of over 140 billion EUR to the development of semiconductor technology (specifically processors and 2nm technology) guarantees a dynamic market development and eventually will benefit the young, the ambitious and the scientifically oriented Europeans. Going through the list of the 17 EU member states that have committed to this task, it will be interesting to observe future attempts at M&As in their market directly or indirectly linked to this area of technology.