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Europe Needs a Dynamic International Investment Regime with China

Academic thinking on foreign direct investment has evolved over the years. This paper reviews this evolution for its usefulness in understanding EU-Chinese investment relations today. It then explores the idea of a new dynamic policy regime as a more appropriate means to address the complex issues of investment liberalisation rather than the traditional trade liberalisation approach.

Economic relations between the EU and China have expanded enormously over the past two decades. China is now the EU's second largest trading partner after the United States and its fastest growing export market, while the EU is the largest market for China's exports.

China's rise to become the second largest economy in the world has been built on trade. Export-led growth has served as a successful strategy for China's integration into the international economy. But the limits of this policy are now evident as global trade imbalances have built up to unsustainable levels. The Chinese authorities themselves now recognise that export-led growth could become a zero-sum game for China and detrimental to the world economy if pushed too far. China is, therefore, reorienting its economy towards a new economic growth model. An integral part of this new economic development is the transformation of its economy from a trading power to an investment one.

Since the 1980s, China has invited foreign investment in to foster its economic development. Today, the EU is the largest foreign investor in China, accounting for 20% of total foreign investment. But this is a very small percentage of total EU investment – accounting for only 2-3% – compared to the 30% of total European investment that goes to the United States.

The Chinese government now predicts that China's outbound FDI will overtake its inward foreign investment in the next few years. China's foreign investment has surged since 2004, continuing to increase during the global financial crisis and expected to grow by 20% to 30% in the next five years. Europe has become the number one location target.[1] Chinese investment in Europe is still very small according to official EU sources, but recent data derived from private company sources show much higher volumes.[2]

The policy environment for investment is starkly different in Europe and China. Since the 1960s, EU countries have engaged in a co-operative framework for progressively liberalising their investment regimes on a non-discriminatory basis under the auspices of the Organisation for Economic Cooperation and Development (OECD).[3] This liberalisation has now been embedded in the EU and guaranteed by the EU treaty. As a result of this, the EU is now very open to foreign investment.

While China has made considerable progress since the late 1990s in adopting international legal standards for the protection of foreign investment, there has been very limited liberalisation. The Chinese government retains discretionary controls over the right of establishment and only grants investment protection to companies after they have been accepted for entry and establishment.[4] Against this backdrop, a fundamental divergence of interests has emerged: while improving market access to the Chinese market is a priority for the EU,

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1 Q. Ding: ODI set to overtake FDI within three years, in: China Daily, Beijing, 5 June, 2011.

2 The Madariaga Report: What Sort of EU China Investment Treaty Do We Need?, 23 February 2012 offers detailed coverage of all Chinese investments in Europe. T. Hannemann, D.H. Rosen: China Invests in Europe: Patterns, Impacts and Policy Implications, June 2012, only provides data on investments larger than one million dollars.

3 The OECD's two complementary policy instruments are the "Code of Liberalisation of Capital Movements" and the "National Treatment Instrument".

4 S.W. Schill: Tearing down the Great Wall: the New Generation Investment Treaties of the Peoples' Republic of China, in: Cardozo Journal of International & Comparative Law, Vol. 15, No. 3, 2007, pp. 74-118.

Chinese investors already have access to a very open European market.

The new surge of Chinese foreign investment in Europe has raised the spectre of "China buying up Europe" at bargain basement prices in the midst of the eurozone's unprecedented debt crisis.[5] But it is not only in Europe that such fears exist. Even those who are fundamentally favourable to Chinese investment have expressed concerns about the lack of transparency surrounding the activities of Chinese firms, their frequent use of tax havens and their potential for "asset-stripping" high-technology companies. Moreover, there is widespread suspicion of economic unfairness because China's firms are perceived to be subsidised by the Chinese government.[6]

The fears are as much about political as economic factors because of the role played by government agencies such as the Chinese Development Bank and the more recently created sovereign wealth fund – the Chinese Investment Corporation (CIC). This government owned and controlled investment fund is financed from China's massive foreign reserves, and its express purpose is to increase the wealth of the Chinese state.[7] The CIC has now identified infrastructure investment as a major priority in Europe. Proposed investment projects would include various forms of participation in key service sector industries such as transport, telecommunications, electricity, gas and water supplies.[8] This would create a qualitatively new situation in which the role of the Chinese government would change from that of creditor to owner in sectors of strategic significance for national security.

There are no multilateral rules governing international investment comparable to what exists for trade. All European efforts to establish a multilateral investment agreement have failed in the past – largely because of strong opposition from Asian countries. However, the situation is changing as Asian countries, and particularly China, are now capital-exporting countries themselves.

So the time is ripe for thinking about new approaches to developing an international investment regime.

The Lisbon Treaty has given new powers to the EU to develop a common policy for foreign direct investment as a counterpart to its common foreign trade policy.[9] The European Commission (EC) has already taken the first steps towards a new European investment policy and has identified China as a key partner for an investment agreement. As China is now set to become a global investor, it is imperative to level the playing field: EU investors must achieve additional market access to China, given that the EU market is already open to Chinese investment.

This paper can only present an ex ante analysis of an EU-China investment agreement, as preparations are still at an early stage and quantification of Chinese investment in Europe is incomplete. The objective is rather to stimulate debate about how European policymakers should respond to the new situation as they start to negotiate a new set of rules for international investment with China.

Europe and Foreign Investment: Evolving Analysis

Europe has a long history of foreign investment. In the nineteenth century when Europe was a major capital exporter to the rest of the world, FDI was not discussed at all as a separate form of investment from foreign portfolio investment. Foreign direct investment was considered as a form of capital flows.[10]

When Europe became a major capital importer from the United States after World War Two, the analysis of FDI became largely separated from capital flows and directly associated with the activities of multinational corporations (MNCs). In this framework FDI was determined by the real decisions of the managers of MNCs who devised their international investment strategies to complement their international trade positions. The modern concept of FDI thus became anchored in micr-

5 F. Godement, J. Parello-Plessner, A. Richard: The Scramble for Europe, in: European Council on Foreign Relations, Policy Brief, 2011, pp. 1-11.

6 D.H. Rosen, T. Hanemann: China's changing outbound foreign direct investment: Drivers and policy implications, Peterson Institute for International Economics, Policy Brief, No. 14, Washington DC 2008, pp. 1-21.

7 Sovereign wealth funds are defined as government investment funds which are funded by foreign currency reserves, but they are managed separately from official currency reserves. See S. Jen: Sovereign Wealth Funds: What they are and what's happening, in: World Economics, Vol. 8, No. 4, 2007, pp. 1-7.

8 J. Liu: China can help the west to build economic growth, in: Financial Times, 28 November, 2011.

9 Articles 206 and 207 of the Treaty on the Functioning of the European Union (TFEU), which is the new name given to the Lisbon Treaty when it entered into force in December 2009.

10 The changing role of FDI in the broader story of capital flows from 19th century Europe to the post-World War Two period when the USA became the dominant foreign investor is given by R. Lipsey: The Role of Foreign Direct Investment in International Capital Flows, in: M. Feldstein (ed.): International Capital Flows, University of Chicago Press, 1999, pp. 307-362.

oeconomic-trade analysis in which capital flows played little or no role.[11]

This approach is reflected in the definition used by the IMF and the OECD. According to their guidelines, FDI exists when the foreign investor owns a sufficiently large amount of the company shares to allow for significant influence over the management of the company. Absolute control is not required for this. The benchmark position is ownership of at least ten per cent of the shares. When the foreign investor owns less than ten per cent, it is considered as foreign portfolio investment (FPI).

Today, the boundary between FDI and FPI is no longer so sharply drawn. Decisions in multinational firms are taken by managers but the ultimate investors are the shareholders, and their goal is to get the highest return on their capital. So the two different kinds of investment are fundamentally similar from an economic perspective. But they may be used in different circumstances. They may reflect different attitudes towards risk and the use of different kinds of investment to diversify risk among countries. For example, Chinese FDI flows into Europe are part of a wider government strategy to diversify its foreign investment away from American sovereign bonds into productive real investments in Europe.

This thinking about investment in a general way has led to some reconsideration of FDI as a form of capital flows.[12] It brings a new understanding of the role of exchange rates in determining FDI and how mergers and acquisitions may be viewed as a form of capital flows in that they aim to "optimise the capital stock" of the acquired firm. This brings FDI back into the macroeconomic financial approach and has implications for the liberalisation of capital markets.[13]

America's Post-War Investment Flows into Europe

Europe gained greatly from inflows of American investment in the post-war period. That investment focussed on three major factors relating to the activities of MNCs: ownership of firm-specific assets (leading-edge technology, brands, management expertise, etc.), the choice of a foreign country in which to locate a production plant (size of market, trade regime, labour skills, etc), and the choice concerning which assets are kept internal to the firm and which are traded openly in external markets (protection of intellectual property rights as opposed to technology licensing). This paradigm of ownership-location-internalisation (OLI) is the basis of the modern theory of FDI and has dominated academic thinking and policy liberalisation approaches since the 1960s.[14]

American MNCs investing in Europe from the 1960s on transferred knowledge assets from the US parent company to the subsidiary in Europe, usually in the form of greenfield investment. The superior competitiveness of the American firms spilled over into indigenous firms, which were able to incorporate the new industrial ideas and upgrade accordingly. European firms soon caught up with their American counterparts, and they began to invest abroad themselves, resulting in two-way FDI flows across the Atlantic. In fact, the roles even reversed, with the United States becoming the largest recipient of inward FDI from Europe in the late 1980s. Europe emerged as the largest source of foreign investment into the United States.

To summarise, the OLI paradigm explains how foreign investment brought mutual gains to Europe and the United States as two-way flows of FDI grew between them. Economic welfare gains were reflected in increased trade – usually in the form of intra-industry and intra-firm trade. Of major importance in this context is the existence of an open policy environment that allows the economic gains to be reaped from two-way flows of investment.

Is Chinese Foreign Investment in Europe Different?

Europe is now the largest export market for Chinese goods, yet no major Chinese brand has captured the imagination of European consumers. Quite the contrary – it is rather Chinese investors who are intent on acquiring famous European brands. This begs the question about how competitive and innovative indigenous Chinese firms are compared to their European counterparts. Have they developed their own firm-specific assets that are considered essential to compete in the international economy?

11 J.R. Marcusen: Multinational Firms and the Theory of International Trade, Cambridge, MA 2002, MIT Press.

12 A. Razin, E. Sadka: Foreign Direct Investment: An Analysis of Aggregate Flows, Princeton 2007, Princeton University Press.

13 K. Russ: The New Theory of Foreign Direct Investment. Merging micro-level and macro-finance, in: International Finance, Vol. 12. No. 1, 2009, pp. 107-119.

14 J. Dunning: An Eclectic Paradigm of International Production; A Restatement and some Possible Extensions, in: Journal of International Business Studies, Vol. 19, No. 1, 1988, pp. 1-31.

Much publicity has surrounded China's catch-up policies in a few prominent high technology sectors, notably high-speed rail transport, information technology, automobile assembly and the civil aviation sector. They are largely the product of industrial policy to produce China's own "national champions". But what is the overall situation? Recent research shows that on an aggregate level, the spillover from foreign manufacturing MNCs to indigenous firms remains relatively thin and that foreign companies are still making the major contribution to technology development in China.[15]

The situation is similar for China's exports of advanced technology products (ATPs). They too have benefited from government industrial policies. But they are still largely associated with processing trade in the regional production networks where the presence of foreign MNCs is particularly strong. These MNCs still dominate the export of ATPs according to recent research which suggests that there has been little innovation by indigenous Chinese firms. In fact, the gap in technology sophistication is increasing.[16]

As the sophistication of technology and skill intensity of China's exports has increased, the percentage of final product value derived from imports of high-value components has grown sharply. China remains a predominantly low-value economy for assembling final products based on imports of more sophisticated parts and components. So, while many Chinese firms have amassed huge profits from sales in the large domestic market, they are not yet equipped to compete on an equal footing with their rivals in European countries. Hence, a major incentive for investment abroad is to acquire this expertise.

Chinese investment abroad is the reverse of the OLI paradigm: it aims to achieve the flow of knowledge from the subsidiary abroad to the parent company at home. Where Chinese firms acquire European firms with high technology or high research intensity, there will be a flow of knowledge from the subsidiary in Europe to the parent company in China. Application of this knowledge in the Chinese market will lead to increased profits through increased sales in the home market, where indigenous firms enjoy preferential status. This scenario is plausible to the extent that European firms cannot compete on an equal footing with indigenous firms in the Chinese market. Protectionist barriers are still pervasive throughout the Chinese economy and European firms constantly complain about the problems encountered when they wish to invest. The fact that Chinese firms have preferential access to the domestic market increases the value of the knowledge assets to be gained by acquiring a European firm. They would even be willing to pay a premium for such firms, as it would be faster and less expensive than developing their own technology.

Chinese Investment in Europe as Capital Flows

In the new macroeconomic approach, acquisitions of firms by foreign investors are considered as capital flows in the sense that the investor seeks to "optimise the capital stock" of the acquired firm. But financial capital alone is not sufficient to improve the productivity of the acquired firm. It must be accompanied by some form of "intangible capital" to augment productivity at a lower cost than setting up a new greenfield investment. Financial capital and intangible assets are complementary; both are necessary to achieve the most productive and efficient management of the acquired company.[17] Real welfare gains from this kind of FDI would require the liberalisation of capital flows between countries. This would realise the benefits from what Razin and Sadka call the "comparative advantage in investing" that different companies in home and host countries have with regard to foreign investment through mergers and acquisitions.[18]

China's greatest foreign investment asset is financial capital. The abundance of capital in China is symbolised by the extent of state wealth that has been built up by ever increasing current account surpluses. This has been achieved by strict controls over the exchange rate and capital flows. The new growth model, which seeks to rebalance the economy towards more domestic consumption and to reduce the current account surpluses, will make more capital available for private Chinese firms to invest abroad.

Re-balancing is also expected to lead to the appreciation of the Chinese currency, so future exchange rate changes will increase the incentives for Chinese investors to acquire European firms. Assuming that the Chinese investor acquires a European firm in euros and receives a stream of profits in yuan as a result of this

15 T. Moran: Foreign Manufacturing Multinationals and the Transformation of the Chinese Economy: New Measurements, New Perspectives, Peterson Institute of International Economics, Working Paper No. 11, Washington DC 2011, pp. 1-26.

16 M.J. Ferrantino, R.B. Koopman, Z. Wang, F. Yinug: The Nature of US – China Trade in Advanced Trechnology Products, in: Comparative Economic Studies, No. 52, pp. 2007-2024.

17 K. Russ, op.cit.

18 A. Razin, E. Sadka, op. cit.

investment, the exchange rate will certainly affect the decision whether to acquire the European company. If the Chinese currency appreciates faster in the next five years, which is quite possible in response to international pressure, this will make it more likely that Chinese acquisitions of European companies will increase. Evidence shows that exchange rates affected FDI flows into the United States in the form of increased foreign acquisitions of firms with high R&D in the 1990s when the dollar was weak.[19]

Inflows of Chinese capital into Europe also involve political factors because of the major role played by China's sovereign wealth fund. The CIC is owned and controlled by the Chinese government; this raises a number of issues concerning both economics and politics. The fact that the CIC is making official reserves available for investment in equities transforms the role of the Chinese government from creditor to the role of ownership and control of European companies – which has major political implications.

The key political issue concerns the interaction between different economic and political institutions that are based on different economic principles and political constitutions. The Chinese government is not accountable to the public like governments in Europe as China is not a democratic society. There are no international standards for cross-border investments by sovereign wealth funds, and there is need for the International Monetary Fund to undertake work in this area.[20]

The liberalisation of capital flows is a controversial issue because it often leads to financial crises. China has frequently warned of the dangers associated with capital liberalisation and has strongly resisted it for fear of ensuing financial instability at home that would provoke social unrest and political instability. Recently, however, China has outlined plans for a very gradual opening up of the capital account. But priority is given to measures oriented towards deregulation of capital outflows, and especially for purposes of foreign direct investment.[21] This further exacerbates the unlevel playing field.

19 B. Blonigen: Firm-specific Assets and the Link between Exchange Rates and Foreign Direct Investment, in: American Economic Review, Vol. 87, No. 3, 1997, pp. 447-465.

20 E.M. Truman: A Blueprint for Sovereign Wealth Fund Best Practices, Peterson Institute of International Economics, Policy Brief, No. 3, Washington DC 2008, pp. 1-11.

21 H. Gao, U. Volz: Is China ready to open its capital account?, East Asia Forum, 29 March 2012, www.eastasiaforum.org.

Why the EU Needs a New Investment Regime with China

Both Europe and China would have much to gain from the creation of a new international investment regime. The main purpose of this regime would be to create a framework for stability that would minimise uncertainty for foreign investors and provide incentives for increased flows of investment. European business views China as an increasingly strategic market for EU investors according to a business confidence survey published by the EU Chinese Chamber of Commerce in 2011. And Europe's open market offers much to China's newly emerging MNCs who are latecomers to global investment.

The present situation does not provide appropriate tools to address the major problem – to redress the asymmetric market access between China and the EU. What currently exists is a patchwork of policy instruments consisting of the following: bilateral investment treaties (BITs) between EU member states and China; limited liberalisation under the multilateral rules of the WTO; a framework of EU-China dialogues which provide for regular meetings to jointly manage the growing number of political and economic tensions in the expanding partnership; and finally the ongoing negotiations between the EU and China for the renewal and updating of the Partnership and Cooperation Agreement (PCA) that dates back to 1985.

BITs were pioneered by European countries in the 1960s for the protection of investment in developing countries.[22] But their use is limited because they contain no provisions for liberalisation of investment and are not backed by international institutions or organisational structures. They are based on the national law of the host country and its application to foreign corporations. Twenty-six EU member states have signed BITs with China. It is noteworthy that the single missing country – Ireland – receives the largest inflows of FDI per capita among EU countries. The United States has invested more in little Ireland than in massive China. The explanation lies in Ireland's open liberal investment regime and its integration into the stable regulatory framework of the EU.

Since the 1990s, China has made progress towards accepting international standards of investment in the

22 For an analysis of the "European Model BIT" see the chapter on Trade and Investment, in: B. Gavin: The European Union and Globalisation: Towards Global Democratic Governance, Cheltenham 2001, Edward Elgar.

new generation of BITs it has concluded. It has loosened up the former tight control over all foreign investment as part of its efforts to support the transition to a market economy and strengthen its integration into the global economy.

However, Chinese BITs contain no liberalisation provisions and China maintains many barriers to entry and discriminatory treatment after establishment. Direct entry barriers faced by EU investors include completely closed strategic sectors (for example, those reserved for state-owned enterprises and state-controlled companies), foreign ownership caps, joint venture requirements, heavy screening of investment and the promotion of "China only" standards. EU companies also complain about unfair procurement practices and customs procedures.

The indirect barriers are those related to the domestic legal system such as lack of transparency, poor implementation and infringement of intellectual property rights. Discrimination problems include subsidies to domestic companies, licensing and authorities.

Since the Uruguay Round, the WTO has extended the trade negotiations approach to investment by its new rules on services under the General Agreement on Trade in Services (GATS). The WTO approach develops a set of rules for the host country on how to treat FDI, focussing on the rights of private investors and a dispute settlement mechanism to ensure that those rights are respected. Although the WTO has made a significant opening towards FDI, it has failed to create the kind of new law that would be necessary for a comprehensive international investment regime.

The WTO has been very beneficial for the liberalisation of trade in goods. But investment is more complex than trade, so the extension of the principles of trade liberalisation to investment would not be straightforward. FDI is an evolving, dynamic process that takes place within a much longer time frame than trade. From the moment the initial foreign investment takes place, the foreign investor becomes a corporate citizen of the host country and is usually committed to a long-term stay. It is to be expected that foreign investors will evolve over the medium to long term with regard to their production practices and standards and that they will have to respond to domestic political regimes which are constantly changing in response to new political and economic conditions.

The WTO regime has been characterised as a static regime in the sense that it is committed to the fixed goal of trade liberalisation. It cannot therefore provide the kind of dynamic multiple-goal regime that would be necessary for investment.[23]

Another major problem for the WTO approach is the lack of internationally harmonised FDI statistics comparable to those of trade statistics. This debate was sparked by Adler and Hufbauer[24] who found no robust empirical evidence to support the link between investment policy liberalisation and increased FDI flows after an extensive review of research studies. The explanation, they concluded, was that the economic literature does not provide an appropriate way to measure precisely the proportion of FDI growth that is achieved by policy liberalisation. This is because most studies have followed the aggregated country approach used by the WTO for purposes of trade liberalisation, which leads to distorted results and misguided policy prescriptions, they argue, the reason being that harmonised data for the FDI statistics of countries are not available in a manner similar to what the WTO has developed for trade.

So how to proceed with liberalisation of investment? To overcome the problem, Adler and Hufbauer[25] advocate a disaggregated, sectoral approach, for which more reliable data is available from private companies. The analytical and empirical foundations of a sectoral approach have already been laid by work in the OECD and this can be further developed. In this context, liberalisation of services is of major importance, as investment in services is the most rapidly growing area of FDI, and the heterogeneity of service industries calls for differential sectoral approaches.

The EU-China Dialogues provide a framework for regular meetings from top-level presidential summits to high-level economic and trade dialogues at the vice-presidential level down to the various working groups composed of specialised experts with participation from industry. An increasing number of EC directorate-generals are involved in those joint discussions, with the Ministry of Commerce as the main partner on the Chinese side. Frustration is growing, however, at the lack of results. The current negotiations for the renewal of the PCA have a very large agenda, and the negotiations are difficult. They have exposed the divergence of interests on investment. China's proposal of an EU-China BIT has

23 K. von Moltke: An International Investment Regime: Issues of Sustainability, International Institute for Sustainable Development, Winnipeg 2000.

24 M. Adler, G. Hufbauer: Policy Liberalization and FDI Growth, 1982 to 2006, Peterson Institute for International Economics, Washington DC 2008.

25 Ibid.

been refused by the EU, while its proposal for market access has been refused by China.

This situation is now set to change as the Lisbon Treaty has given exclusive competence to the EU to develop a common policy for "foreign direct investment" in line with its long established common commercial policy (CCP). As this is a completely new competence, there is much debate in academic and policy circles about how exactly to interpret it. While it clearly signals that investment policy will be developed at the European level from now on, it does not give the EU power over all foreign investment. It is limited to foreign direct investment and excludes portfolio investment. This distinction does not exist in the BITs, which cover all kinds of investment. So some kind of joint action will be needed between the member states and the EU on matters relating to portfolio investment and the regulation of capital flows.

For the current transitional period, the Commission has proposed regulation to ensure that all rights and obligations under the existing BITs will continue to be valid, even as a comprehensive European investment policy is developed. This aims at ensuring stability and confidence that investor rights will not be affected while the EU paves the way for a new European policy. This does not detract from the fact that new treaty provisions clearly state that member states will no longer be able to conclude new BITs in the future without the prior consent of the EU.[26] From this we may conclude that the era of member states' BITs is coming to an end and a new comprehensive investment agreement is emerging at the European level.

Towards a Dynamic EU-China Investment Regime

Since the Lisbon Treaty entered into force in December 2009, the Commission has taken a number of preparatory policy steps. It has engaged with stakeholders on how the new policy should serve European interests and has identified China as a key partner for a new investment treaty.[27]

Preparatory work for a new EU-China agreement has been underway for the past two years in the joint task force established at the top political level. The EU Commission will prepare the relevant legislative proposals and will conduct the negotiations. The EU Parliament will come in at a later stage to ratify the agreement under the new powers granted by the TFEU analogous to those it currently exercises for international trade agreements.

Three policy options for an EU-China investment agreement have been discussed in the initial stages. Option one would be to negotiate a comprehensive investment agreement with China that would cover both liberalisation and protection of FDI. Option two would go for a standalone investment protection agreement to replace the 26 BITs with one single European BIT. That would cover investment protection but not liberalisation. Option three would be a continuation of the status quo: no new investment agreement with China but continued operation under the current framework of bilateral dialogues and continued broader negotiations for an updated and renewed PCA agreement, while leaving investment protection to be covered by the existing 26 BITs.

Option one would be optimal as it would provide for market access and protection of investment in the post-establishment phase. Such an agreement would cover three major areas: pre-establishment market access, standards of treatment in the post-establishment phase and protection against direct and indirect expropriation. An extensive interpretation of all three categories of measures is supported by legal scholars.[28] This would have a positive impact on flows of investment as it would improve conditions for European investors in China and open up new possibilities for them. It would also provide a single legal framework of investment for all EU investors.

The negotiations will undoubtedly be long and arduous. The EU has staked out its position on improved market access as the *sine qua non* for a successful EU-China investment agreement. This would entail a major overhaul of present Chinese investment policy, for example, reform of the role of state-owned enterprises and state-controlled companies, all of which are linked with "economic security" in the Chinese model and considered to be essential parts of overall national security. It is to be expected that this will meet with strong resistance. China now gives priority to liberalising regulations for outbound FDI – including capital outflows – but shows much less willingness to liberalise conditions for inward FDI and capital flows.

26 TFEU, Article 2 (1).

27 The Directorate General for Trade published a communication entitled "Towards a Comprehensive European International Investment Policy" in 2010. And it launched a Consultation on the future investment relationship between the EU and China in 2011.

28 C. Hermann: The Treaty of Lisbon Expands the EU's External Trade and Investment Powers, in: The American Society of international Law Insights, Vol. 14, Issue 28, September 2010.

Europe's market is now open, but will it remain open when severely tested by increasing inflows of Chinese investment? Should the EU require reciprocity in exchange for its unilateral openness? This discussion has already taken place on access to public procurement for EU companies in China. The Commission is currently preparing draft legislation to establish reciprocity in the field of public procurement. Current fears are also fuelling national security concerns – similar to those invoked in the United States. The member states have instruments for national security and the EC considers that it would be misguided to construct the idea of European national security. Nevertheless, some measures will be needed at the European level to preserve the proper functioning of the internal market.

Sensitive political economy issues will permeate the negotiations. So too will the contested issues of corporate social responsibility and labour and environmental standards, which have been requested by the EU Parliament. These issues have derailed past attempts to conclude a "Multilateral Investment Agreement". So what is the way forward? As no "model investment agreement" has yet been proposed by the EU, and given the inadequacies of the traditional trade liberalisation approach already discussed, there is now an opportunity to reflect on an alternative new dynamic investment regime.[29]

Dynamic regimes have emerged in recent decades to provide new forms of governance to manage problems in a wide variety of fields including economic, financial, social and political issues. These regimes have transformed the traditional international organisation approach into a multiple-actor game that brings new players and new approaches to resolving international problems. These regimes have been born from the necessity to tackle new international problems that have emerged and been identified but for which the solutions are not yet known. The EU-China dialogues have already created an informal dynamic regime that has evolved in response to new unsolved questions. It could be extended into a more formal structure to provide for negotiations on substantive issues.

Dynamic regimes create new "institutions" that are understood in the broadest sense as "the rules of the game", which are based on agreed principles, rules and procedures agreed by the partners to govern the specific policy issues of the regime in question.[30] An international investment regime would require a number of different institutions to govern policy rules for the liberalisation and protection of direct investment, some liberalisation of capital flows and standards for the behaviour of MNCs. This requires the creation of multiple institutions of much greater complexity than traditional trade agreements, between which there may well be conflict.

How could such a regime be made operational? One approach that has been commonly adopted in recent years is the Framework Agreement. This type of agreement is specifically designed to evolve over time and has the capacity to adopt different approaches as more knowledge becomes available about problem issues. Framework Agreements have emerged at the European and international levels as an increasingly favoured way to do business among both private and public partners. They have been used at the international level in multilateral environmental agreements and in international codes of conduct for labour standards by multinational corporations. At the European level they have been used in public procurement agreements.

The Framework Agreement would provide for an initial agreement that could be reached in a relatively short time to establish the basic institutions for investment, including the set up of an organisational structure for continuing negotiations. This would establish an ongoing process of negotiations based on a work programme adopted by the parties. The work programme could be largely based on sectoral agreements that would be progressively negotiated over a longer time frame established under the general framework rules.

Dynamic Agreements are characterised by continuous negotiations. They are launched by pre-agreement negotiations but they grow and evolve through post-agreement negotiations. They are ongoing processes that reflect the dynamics of how regimes achieve their most important goal – "getting it done".[31] Continuous negotiations allow regimes to operate, adapt and remain responsive to the vital interests of their stakeholders.

29 K. von Moltke, op. cit., provides a comprehensive discussion of the inadequacies of the trade liberalisation approach and why there is need for a new dynamic international investment regime.

30 The definition and theoretical issues related to new dynamic regimes are discussed by M. Levy, O. Young, M. Zuern: The Study of International Regimes, in: European Journal of International Relations, Vol. 1, No. 3, 1995, pp. 267-330.

31 B. Spector, W. Zartman: Getting It Done: Post Agreement Negotiations and International Regimes, United States Institute of Peace, Washington DC 2003.

This differs from international trade agreements which concentrate all their efforts on pre-agreement negotiations and "getting to yes". Once the agreement is signed, it is taken as final legislation, to be treated as hard law, with the focus on compliance. Parties are expected to implement it and any differences of interpretation with regard to the contents of the agreement that arise are settled though a dispute settlement mechanism. This type of negotiation is extremely lengthy and hardly suitable for today's conditions.

The negotiations between the EU and China will require consensus on essential principles for investment and the interpretation of international investment standards. There may well be different interpretations of those principles when both parties move to implementation. But when different interpretations become apparent and problematic, it would be better to have an institutional structure to allow for negotiations between the parties in an effort to reach consensus than to resort exclusively to an international arbitration tribunal that has limited transparency and lacks political legitimacy. Given the heightened sensitivity to national security in foreign investment policy, this must be taken into consideration.

Continuous negotiations may well be the best way to get an investment agreement implemented. Post-agreement negotiations would allow for a flexible response to changing economic or political conditions. This would allow the regime to evolve by a process of fine-tuning the original goals. These negotiations involve talks at the domestic as well as the international level – to get all of the stakeholders involved. The post-agreement negotiations will determine whether the agreement is a success or a failure because it will, ultimately, determine whether the agreement is implemented or not.

Conclusions

The EU has become the largest foreign investor in China, and European business seeks to expand its investment operations there. They view the Chinese market as an increasingly important strategic market that contains great potential for the future. At the same time, the Chinese economy is in the throes of major structural change as it tackles the problems of rebalancing its economy towards a new sustainable growth path. As an integral part of this structural shift, China is now set to become a global investor.

Europe and China must jointly manage this challenging situation to ensure that the growing flows of investment in both directions will be mutually beneficial. The present situation of Europe's unilateral openness alongside China's increasing restrictiveness is not sustainable. Hence, the need for a comprehensive legal framework for EU-China investment that will create a level playing field. The EU now has the policy instruments to achieve this. Its task is to negotiate an investment treaty that will consolidate the existing investment treaties of the member states into a single European agreement and expand this policy to cover investment liberalisation of the Chinese market.

As Chinese investment grows rapidly in Europe, so do fears about economic security and the special characteristics of the Chinese model of investment. Chinese investors' strongest asset is financial capital and not the technology and management assets that are essential to increase competitiveness in Europe. The EU will need to develop some instruments at the European level to protect against the market distortions that may arise and disrupt the proper functioning of the internal market.

National security fears have also emerged as Chinese government agencies, especially the sovereign wealth fund with its enormous financial power, position themselves to get controlling positions in strategic European companies. At present, the member states control the mechanisms for national security and a concept of European national security does not exist. But it is essential to co-ordinate the different national approaches into one coherent European approach, as this too will impinge on the proper functioning of the internal market. Otherwise, fears will be exploited for purposes of protectionism.

Both EU and Chinese leaders are now committed to move ahead on negotiations to conclude a new investment agreement. Given the divergence of interests that now separate the two partners, the negotiations are expected to be long and difficult. Nevertheless, the launch of the negotiations could create new international momentum as the United States is also currently preparing for negotiations on an investment treaty with China.

Past attempts to create multilateral rules for international investment have all failed. In recent years, new dynamic regimes have been born out of similar failures and the necessity to tackle new problems with new solutions. Framework Agreements have served as a new form of regime that is used to create new institutions and organisational structures for purposes of governance. It should provide food for thought for the policymakers who are designing the EU-China investment agreement.