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Europe and China's looming investment conflict

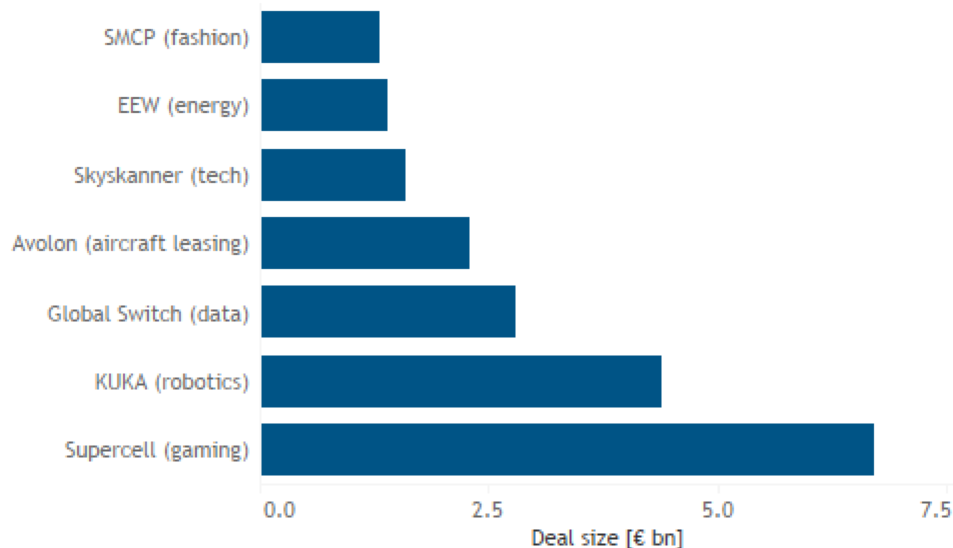
Blog post by Chief Economist Gregor Irwin, 09 March 2017

If you want to understand the state of the EU-China economic relationship, then reading the analysis of China's Manufacturing 2025 strategy by the European Chamber of Commerce in China is a great place to start. It does not bother with the usual, dry statistical analysis of export growth rates and bilateral deficits. Instead, it is a stark exposé of why European businesses find competing in China anything but fair. It sends a strong signal that the political pressure on European policymakers to take a tougher line on Chinese investment and competition in Europe is only going to grow. And it suggests that those hoping a far-reaching bilateral investment agreement will soon be agreed between China and the EU are likely to be disappointed.

China's Manufacturing 2025 strategy was launched in 2015 to support the development of ten advanced technology sectors, as part of China's broader policy effort to improve productivity and sustain high growth rates. The European Chamber concludes that this is not an exercise in free market economics, but is instead an "import substitution plan" based on brute-force government intervention that is skewing the competitive landscape in favour of Chinese firms. The report lists ten policy levers used as part of the strategy, most of which would be unrecognisable in the European policy tool box and which would be unlikely to withstand scrutiny by DG Competition. These include some familiar forms of Chinese state support, such as central government subsidies, accommodative financial policies, market access restrictions, and local government assistance. They also contain two that, while not new, are now central to what promises to become a more confrontational relationship between the EU and China – forced technology transfers and technology-seeking investments abroad.

European companies complain they are increasingly being required to hand over leading technologies in return for market access in China and this is now damaging their competitive position. The acquisition of technologies through foreign investment by Chinese firms in Europe has, meanwhile, caught the attention of policymakers as the scale of investment has grown, with direct investment in Europe jumping 77% in 2016 to reach €35bn and with high-tech firms among the top targets (Fig.1). For many years, European governments have been competing for Chinese investment; now many are undertaking a rethink. Most importantly, the German government is calling on the EU to allow member states to block investments in strategic sectors, with Chinese state-backed acquisitions linked to technology the main target.

Major Chinese investments in 2016



Source: Rhodium Group

Is this just another example of European protectionism, led by a country in an election year? Possibly, after all the acquisition of companies for their technology is hardly new and has been a feature of European and US business for many years. But in all probability, it is not. The argument being used in Berlin and Brussels is as follows. Europe's best businesses want to deploy their leading technology in China but can't, at least not without giving it up. But if they pass on the Chinese market they are vulnerable to a Chinese takeover, because Chinese firms are able to pay a premium based on their privileged access to the Chinese market. The scale of the Chinese market now means that this premium can be huge, particularly in sectors like new energy vehicles or renewables. In effect this is a sophisticated extortion, backed by the Chinese state.

And that's why the prospects for a meaningful bilateral investment agreement look rather bleak. It is not just that any such deal would need to be broad and get into thorny issues such as labour and environmental standards, which the Chinese would find uncomfortable. It's more that at its heart, there would need to be a credible commitment not to discriminate between companies based on nationality, which is directly contrary to current Chinese economic policy. Without an agreement, the EU will most likely need to heed German advice and work out a more assertive response to Chinese policy. While there is little that can be done, beyond exhortation, about the terms of access European companies enjoy in China, there is room for a more restrictive approach to Chinese investment in the EU. So that is most likely what will happen. And that means the EU-China economic relationship will likely get quite a bit worse, before there is any prospect of it getting better.

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