The Greater European Journal
Volume 3, Number 1, December 2021. pp. 59-64 ISSN: 2633-2051

The Challenges of the EU-China CAI: Analysis from a Two-Level Game Approach

Xiaowen Hu[1]

Abstract

In 2020, the European Union (EU) and China reached an agreement that set the principles for the EU-China Comprehensive Agreement on Investment (CAI). 7 years of negotiation indicate both a willingness to reach a consensus on investment and the divergence between the two parties. This paper utilizes Putnam's two-level game to analyse the "win-sets" of both parties and their overlap in order to answer what motivates and hinders the two parties to reach agreement during the long-lasting negotiation.

For the EU, legally speaking, the Union is entitled to establish investment relations with China with exclusive competence, so that the existing bilateral framework between member States and China can be updated in pursuit of greater reciprocity and a level-playing field. From a strategic perspective, CAI conforms to the strategic outlook of "Effective Multilateralism" and China-EU 2020 Strategic Agenda for Cooperation. Internally, Brexit, separating the EU from China's largest investment destination within the Union, strengthens the EU's willingness to conclude CAI, while there is doubt whether the CAI can be ratified in the end.

For China, the EU occupies strategic importance on China's development agenda, from its "Going Global" strategy to the Belt and Road Initiative (BRI). The challenge posed by the US-China trade war pushed China closer to the EU. Domestically, China's legislation has included the Foreign Investment Law (FIL) in 2019, and Chinese businesses have expressed similar expectations of the investment deal. However, the complexity of China's governing pattern makes it difficult for the EU to find the right interlocutor.

Despite the strong motivation of both parties to conclude the CAI for pursuing investment fairness, different business cultures have led to a divergence of understanding regarding fairness, with the EU focusing more on market access and issue linkage with environment and human rights and China more concerned with the foreign direct investment (FDI) screening mechanism

Introduction

Despite maintaining strong economic relations, the European Union (EU) and China did not reach agreement on the EU-China Comprehensive Agreement on Investment (CAI) until after 35 rounds of negotiation over 7 years, demonstrating the difficulties of reaching consensus. This paper seeks to understand the motivations and difficulties for both parties to conclude the agreement during the long-

[1] After obtaining a Master degree of EU International Relations and Diplomacy at the College of Europe, Xiaowen Hu is currently engaged in area studies of francophone countries in China.

lasting negotiations, by adopting Putnam's two-level game approach. According to Putnam, in negotiations involving interaction between domestic and international actors, agents at both "levels" have "win-sets" consisting of all the possible agreements to be ratified, with agreement being reached only when these win-sets overlap (Putnam, 1988).

Based on this "two-level game", this paper first analyses the EU's win-set by examining the investment potential with China, the EU's strategic pursuit, member States' attitudes, and the role of institutions in the negotiation and ratification processes. The second part will be dedicated to the analysis of China's win-set, from the perspective of the economic and strategic importance of the EU, China's governance style, domestic preferences and the impact of the trade war between the United States (US) and China. The third part will then compare the common grounds and divergence of each party's win-set to identify an overlap. This paper argues that the divergent understanding of fairness exacerbated the difficulty of negotiation in spite of the strong overlap of both parties' win-sets.

The shaping of the EU's win-set

For the EU, China has economic and strategic implications, making up the cost of no agreement. In economic terms, China was a crucial player in international trade and investment while the potential of investment between the EU and China was not fully discovered. With 13 billion EUR of investment in China and 18 billion EUR flowing from China to the Union in 2014 (Rhodium Group, 2016), imbalanced FDI flows demonstrated the importance of a fair investment environment under the framework of CAI. Moreover, faced with the stagnation in the EU after the financial crisis and European debt crisis, Chinese investment could be a boost for the revitalization of the EU economy. For example, by 2013, Asian investors including those from China had already bought 22% of European Financial Stability Facility (EFSF)/European Stability Mechanism (ESM) bonds (Tzogopoulos, 2016). Besides investment potential in the context of economic recovery, the EU-China CAI would conform to the EU's strategic pursuit. Multilaterally, in the context of Trump's unilateralism (Thompson, 2018), an effective engagement in China became vital for the EU's strategy of "Effective Multilateralism" considering the influencing role of China in many multilateral settings such as the World Trade Organization (WTO). Bilaterally, the China-EU 2020 Strategic Agenda for Cooperation classified a comprehensive EU-China Investment Agreement as a key initiative to boost prosperity (European External Action Service, 2013), demonstrating the EU's strong willingness to conclude the CAI. At the member States-level, the shortcomings of existing bilateral frameworks made up their preference for a comprehensive one at EU level. All of the EU member States except Ireland had already signed Bilateral Investment Treaties (BIT) with China (European Parliament, 2020), but European enterprises might receive different treatment when investing in China. Besides the divergence of investment regulations in member States, existing investment treaties were not sufficient to regulate China's investment. Mostly signed at the starting point of China's reform and opening-up policy when Chinese foreign investment had hardly been developed, the existing frameworks primarily regulated the outward investment from EU member States to China, instead of the inward investment in the other direction. According to the Commission's assessment, an agreement at the EU-level can provide more certain legal protection than the status quo (European Commission, 2013). As a result, concerns about using investment as a political tool arose (Dominguez-Jimenez et al., 2020), and member States developed an interest in the EU-China CAI to fix the lack of reciprocity and develop a fair investment environment.
The role of EU institutions was strengthened in the negotiation of the investment agreement from 2009. With the coming into force of the Lisbon Treaty, foreign direct investment became an exclusive competence of the EU (Treaty on the Functioning of the European Union, 2012), so the EU, rather than its member States, was capable of concluding one single comprehensive agreement to replace the existing

bilateral BITs and joint agreements. The CAI also includes provisions on environment, which falls within shared competence (Treaty on the Functioning of the European Union, 2012). In this regard, the CAI may be considered a mixed agreement requiring ratification by the European Parliament and the national parliaments of member States, which may involve more potential veto players. Moreover, the European Parliament, despite its consultative role, plays an important role in the negotiation. The European Parliament, often holding a negative attitude towards the human rights situation in China (Goodman, 2020), insisted on introducing a human rights clause in the CAI negotiation and considered it as the redline for ratification, increasing the Commission's bargaining power. Indeed, the freezing of CAI ratification following the human rights sanctions between two parties (European Parliament, 2021) provides further evidence of the prioritisation of human rights engagement over investment opportunities in China, requiring a tougher bargaining position of the Commission.

Brexit may have cast possible reverberation effects on the negotiation due to the importance of the United Kingdom (UK) for Chinese investment in the EU. The British strategy of presenting itself as the gateway to the EU (Ryan, 2017) attracted Chinese investors so as to become the largest investment destination in the EU. Judging from the cumulative inward FDI from China between 2000 and 2009, the UK received 50.3 billion EUR, 3 times more than the total transaction to France (Kratz, et al., 2020). The withdrawal of the UK from the EU might create an investment vacuum, constitute an opportunity to absorb Chinese investment that used to be occupied by the UK. Brexit reverberates with the possibility of the EU receiving more investment from China, which made the CAI negotiations more important for the EU.

Altogether, the EU's win-set during the negotiations was mainly based on investment potentials, strategic interests, legal preferences and opportunities after Brexit, but has been constrained by the potential veto players. In short, the issue linkage with human rights required by the European Parliament and its role in the ratification limit the agent autonomy of the European Commission.

The shaping of China's win-set

The cost of no agreement for China can be understood from both economic and strategic angles. The EU, with its tremendous market dynamics and economic power, was the biggest economy and the largest trade partner of China for years (Mission of the People's Republic of China to the European Union, 2019). With its "Going Global" strategy, China has been committed to international trade, where the EU is an important player. The EU was also vital for the Belt and Road Initiative (BRI) because it is not only the Western end of the ancient Silk Road but also the intersection of the Silk Road Economic Belt and the 21st Century Maritime Silk Road.

In terms of political institutions, China followed a "fragmented authoritarian" governing style where final implementation would depend on the internal consensus within the segmented executive. The Ministry of Commerce (MOFCOM, 2019) had to present the negotiating position to the State of Council. However, the measures "behind the border" (Mertha, 2009) such as the approval of investments would fall in the responsibility of regional and local authorities. That is to say, there is a risk of "involuntary defection" that might result from insufficient coordination with actors in civil society – for example, local businesses – who might influence implementation on the ground.

With regard to national preferences, China hoped to establish a protection mechanism both in China and in the EU. Chinese businesses were willing to welcome inward investment to China, as shown by the adoption of the FIL in 2019. The FIL provided EU investors with equal treatment, such as participation in public procurement. Although the FIL narrowed the EU's cost of no agreement, it illustrated China's sincerity in creating a harmonious investment environment. In the EU market, Chinese businesses upheld the same expectation, because the strict investment screening in the EU increased the investment cost and discouraged their investment passion. Among the Chinese enterprises which had gone through EU investment scrutiny, 48.8% of them reported receiving discriminative treatment and 78.8% thought that the scrutiny had negative effects on their performance in the EU market (Zhao et al., 2020).

The US-China trade war also had repercussions on the EU-China CAI negotiations. American protectionism and unilateralism reverberated in the investment negotiations with the EU, and sharing the value of multilateralism became more important to China for its future international engagement. Moreover, the cost of no agreement increased as it would be difficult for China to find an alternative to the US.

Overall, China's win-set has been shaped by economic and strategic interests, heterogeneous domestic preferences and the EU's increasing importance in the context of US-China trade war, but can be limited by difficulties in implementation. Through the analysis of negotiation difficulties from China's side, it can be understood that the gap between negotiation and implementation in China may not effectively address the EU's concerns over market access, so the possible involuntary defection of agents can undermine the negotiation process.

Overlap of win-set

At the beginning, the EU had a larger win-set because a harmonious investment relation with China would be important in the context of economic recovery. It was also necessary for the EU, with its exclusive competence, to establish a uniform investment protection mechanism to replace the outdated existing bilateral frameworks. Otherwise, the EU might not be able to attract enough Chinese investment to boost its economy. However, with the promotion of the BRI and the outbreak of the US-China trade war, China could be said to have had a larger win-set than the EU, because the strategic importance of EU-China relations increased the cost of no agreement. For China, the EU was an inevitable interlocutor in the implementation of the BRI due to its economic power and specific geographical position. Moreover, its economic ties with the EU, an actor that shares the value of multilateralism, would be helpful for international engagement in times of the US-China trade war.

In spite of the common expectation for a fair investment environment through the CAI, the overlap was narrowed because of the divergent understanding of fairness which responds to difficulties in the negotiation. For the EU investors, they hope for market access in China, with the belief that fairness means equal opportunities for EU companies to compete with Chinese ones on the Chinese market. That helps explain why the lack of a level playing field for EU investors in China is considered as a major problem at stake during the public consultation of the EU (European Commission, 2013). For the EU institutions, especially the European Parliament, the lack of issue linkage between investment and human rights does not contribute to a fair investment environment. For China, the strict investment screening in the EU is unfair for private-sector enterprises which are not as strong as State-owned enterprises, so Chinese interest lies in less strict scrutiny for Chinese investment. To tackle the dilemma, the two parties should make efforts for a common rule-based negotiation instead of insisting on their own rules.

Conclusion

The EU's win-set is determined by the potential of balanced investment, strategic interests, the shortcoming of existing frameworks, and the investment vacuum after Brexit but may be narrowed by ratification procedures and issue linkage with human rights. The Chinese win-set depends on its economic and strategic concerns, and the US-China trade war but can be constrained by involuntary defection caused by "fragmented authoritarianism". The EU, with the need to revitalize the economy, had a larger win-set at the beginning of negotiations, but the situation changed due to the increasing strategic importance of the EU for China, especially in the context of the BRI and the trade war. When looking into the obstacles during the CAI negotiation, this paper finds that the divergent approaches towards fair investment leads to different interests of the two parties, making the negotiation difficult despite the overlap of win-set.

Putnam's two-level game has its limitations when used to analyse the stalemate of international negotiations. Putnam argues that agreement is possible only if those win-sets overlap, and the larger each win-set, the more likely they are to overlap (Putnam, 1988). In this case study, despite the overlap such as the pursuit of multilateralism and the expectation towards investment fairness, the negotiation was still time-consuming because of different culture and investment practices. Moreover, in order to analyse the stalemate, it is difficult to compare whether the overlap or the non-overlap plays a more important role, indicating that this approach can be only used to explain the stalemate, not to predict its possibility.

References

Dominguez-Jimenez, M. and Poitiers, N. 2020. *Europe's China problem: investment screening and state aid*, [Online]. Brussels: Bruegel, [Accessed 13 Oct. 2020]. Available from https://www.bruegel.org/2020/07/europes-china-problem-investment-screening-and-state-aid/

EU Delegation to China. 2019. *EU-China 2020 Strategic Agenda for Cooperation*. [Online]. [Accessed 16 Oct. 2020]. Available from: https://eeas.europa.eu/delegations/china_en/15398/EU-China%202020%20Strategic%20Agenda%20for%20Cooperation

European Commission. 2013. *Impact Assessment Report on The EU-China Investment*

European Parliament. 2020. *EU–China Comprehensive Agreement on Investment: Levelling the playing field with China*. [Online]. Brussels: European Parliamentary Research Service. [Accessed 26 Dec 2020].

European Parliament. 2021. *MEPs refuse any agreement with China whilst sanctions are in place*. [Online]. [Accessed 27 Aug 2021]. Available from: https://www.europarl.europa.eu/news/en/press-room/20210517IPR04123/meps-refuse-any-agreement-with-china-whilst-sanctions-are-in-place

Goodman, S. 2020. EU parliamentarians must insist that the inclusion of a human rights clause is a redline when it comes to ratifying an EU-China investment partnership. *Hongkongwatch*, [Online]. 26 October. [Accessed 12 Oct. 2020]. Available from: https://www.hongkongwatch.org/all-posts/2020/10/26/eu-parliamentarians-must-insist-that-the-inclusion-of-a-human-rights-clause-is-a-redline-when-it-comes-to-ratifying-an-eu-china-investment-partnership-1

Kratz, A. et al. 2020. *Chinese FDI in Europe: 2019 Update*. [Online]. Berlin: Mercator Institute for China Studies. [Accessed 12 Oct. 2020]. Available from: https://rhg.com/research/chinese-fdi-in-europe-2019-update/

Mertha, A. 2009. "Fragmented Authoritarianism 2.0": Political Pluralization in the Chinese Policy Process. *China Quarterly*. **200**, pp.995–1012.

Mission of the People's Republic of China to the European Union. 2019. *Report on EU-China economic and trade cooperation 2019*. [Online]. [Accessed 11 Oct. 2020]. Available from: http://images.mofcom.gov.cn/eu/202003/20200306182920737.pdf

Putnam, D. 1988. Diplomacy and Domestic Politics: The Logic of Two-Level Games. *International Organization*. **42**(3), pp.427-460.

Relations. [Online]. Brussels: Commission Staff Working Document. [Accessed 27 Aug 2021]. Available from: https://ec.europa.eu/smart-regulation/impact/ia_carried_out/docs/ia_2013/swd_2013_0185_en.pdf

Rhodium Group. 2016. *EU-China FDI Monitor 4Q 2015 Update: Public Version*, [Online]. [Accessed 15 Oct. 2020]. Available from: http://trade.ec.europa.eu/doclib/docs/2016/march/tradoc_154343.pdf

Ryan, J. 2017. Does Brexit pose danger both for European Union and China?. *Brexit Partners*, [Online]. 3 October. [Accessed 6 Oct. 2020]. Available from: https://www.brexit-partners.com/blog/2017/10/3/does-brexit-pose-danger-both-for-european-union-and-china

Thompson, J. 2018. The Appeal of "America First". In Jervis R., Gavin F., Rovner J., Labrosse D., & Fujii G. Eds. *Chaos in the Liberal Order: The Trump Presidency and International Politics in the Twenty-First Century*. New York; Chichester, West Sussex: Columbia University Press, pp. 151-157.

Treaty on the Functioning of the European Union, 26 October 2012. [Online]. 2012/ C 326/49. [Accessed 18 Oct. 2020]. Available from: http://eur-lex.europa.eu/

Tzogopoulos, G. 2016. China and Juncker's Investment Plan. *Vocal Europe*, [Online]. 29 January. [Accessed 8 Oct. 2020]. Available from: https://www.vocaleurope.eu/china-and-junckers-investment-plan/

Zhao, P. et al. 2020. *Business Environment of the European Union 2019/2020*. [Online]. Beijing: Academy of China Council for the Promotion of International Trade. [Accessed 10 Oct. 2020]. Available from: http://www.ccpit-academy.org/v-1-4220.aspx