Briefing

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Foreign direct investment screening

A debate in light of China-EU FDI flows

SUMMARY

In 2016, the flow of Chinese foreign direct investment (FDI) into the EU hit record levels, in sharp contrast to the continued decline in EU FDI flows to China. Chinese FDI was mainly driven by market-seeking and strategic asset-seeking motives and focused on big EU economies, targeting cutting-edge technologies in particular.

In 2016, a number of Chinese proposals for transactions in strategic sectors came under scrutiny during security reviews at EU Member-State level. Some were delayed, and some were ultimately withdrawn by the Chinese investors. In this context, new challenges going beyond national security have emerged in terms of economic security. Such challenges may arise from alleged 'unfair competition' from China, which the current regulatory framework seems unable to address.

This has sparked a debate about whether the patchwork of different mechanisms for screening FDI on national security grounds currently in place in nearly half of the EU Member States, coupled with the scrutiny of mergers and acquisitions under EU competition rules, are adequate regulatory tools for tackling the perceived new challenges. It also raises the question of whether the Member States' diverging approaches should be upgraded, better coordinated or even replaced by a new consistent FDI screening mechanism at EU level.

Australia, Canada, Japan and the USA operate FDI screening mechanisms, which the EU could use as sources of reference but not emulate entirely. The use of these screening mechanisms for, and their deterrence effect on, Chinese investors in a growing protectionist climate is, however, likely to have an impact on the EU.

In this briefing:

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Introduction

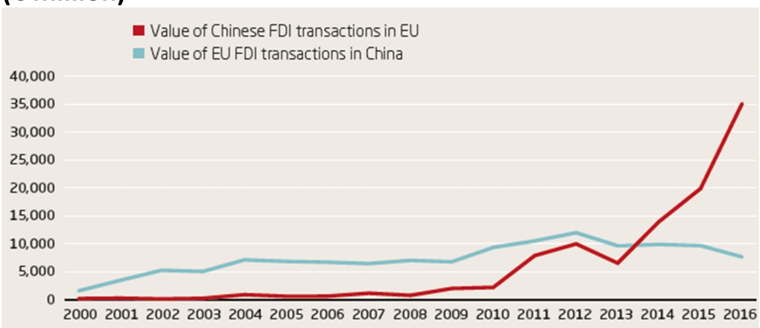
In 2016, there was a dramatic increase of Chinese FDI inflows into the EU, which raised unprecedented concerns by regulators in some Member States about their economic and security impact, resulting in several Chinese transactions being delayed or withdrawn. In general, economic and security concerns linked to FDI may be addressed through EU competition law at EU or Member State level and/or with FDI screening procedures on national security grounds, if any, at Member State level. While EU competition rules ensure that mergers and acquisitions do not result in concentration of economic power or the distortion of competition in the internal market, some Member States have FDI review procedures to screen FDI for potential threats to national security. However, neither of the above regulatory mechanisms scrutinises whether FDI from private or public sources may benefit from foreign-state funding for the implementation of national industrial policy goals. Consequently, 2016 saw a growing perception among certain Member States that the existing mechanisms are not suitable for tackling concerns about alleged 'unfair competition' from China, which may harm the EU's industrial base, long-term global competitiveness in strategic sectors, and hence its future economic prosperity.

This perceived regulatory gap has given rise to a debate on the need for legislative action. The debate was launched officially in February 2017 by the French, German and Italian ministers of the economy with a common letter to EU Commissioner for Trade, Cecilia Malmström. While waiting for the possible response from the EU institutions to this initiative, it is pertinent to set out the background by looking at aspects of recent China-EU FDI flows, the challenges linked to China as an emerging global investor with specific charasteristics, the current patchwork of Member States' FDI screening mechanisms and the key features of FDI screening mechanisms used by other major economies, which may or may not serve as a model for the EU.

Trends in China-EU FDI flows

In line with the global trend of certain emerging economies playing an increasing role as net capital exporters, China has shifted from being a leading destination of FDI to also being a major provider of outbound FDI, including to the EU. Since 2013, FDI flows between China and the EU have moved in opposite directions (see Figure 1).[1]

Figure 1 – FDI transactions between the EU-28 and China (€ million)



Data source: Record flows and growing imbalances, Merics, 2017, p. 5.

Drivers of Chinese FDI flows into the EU

Contrary to Chinese global FDI, which had already started increasing at the beginning of the 2000s following the launch of China's Going Global policy, the country's FDI to the EU only gained traction slowly in the wake of the 2008 financial crisis. After 2010 a gradual relaxation of China's outbound FDI regime, foreign exchange controls and capital account spurred the inflow of its FDI into the EU.[2] The rise in Chinese FDI in 2013 coincided with the arrival in power of President Xi Jinping, economic reform decisions taken at the Third Plenum of the Chinese Communist Party (CCP) and the launch of the One Belt One Road (OBOR) connectivity initiative covering Eurasia, parts of Africa and the Middle East. New Chinese funding tools, such as the Silk Road Fund and the Asian Infrastructure Investment Bank (AIIB), created for the implementation of OBOR, have provided further momentum for Chinese firms to invest abroad. Other drivers have been the plans to reallocate China's abundant foreign exchange reserves from low interest-bearing US Treasury bonds to higher-yielding assets, and to internationalise the Chinese currency. The transition of China's export and investment-reliant growth model to the 'new normal' of a slower, more sustainable and inclusive growth pattern, based more on domestic consumption and services, has gone in tandem with ambitious aims to move beyond being the world's largest manufacturer to high-technology supremacy.

Two blueprints serve to accomplish the above strategic vision. The first is China's 13th five-year plan (2016-2020) for innovation-driven, green and inclusive growth. The second is the Made in China 2025 strategy, which aims to drastically diminish the high level of foreign content in Chinese manufacturing and replace it with indigenous content, and to create 'national champions' in 10 high-tech manufacturing sectors. The way it is conceived suggests an increasingly competitive rather than complementary EU-China relationship, where Chinese FDI is focused on acquiring EU brands, know-how and cutting-edge technology firms, such as German robotics company Kuka in 2016.

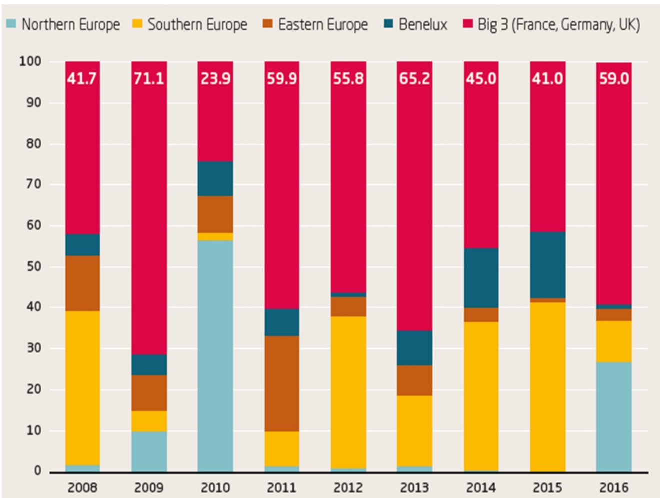
Chinese FDI flows into the EU

In 2016, Chinese FDI hit an all-time high at global and EU levels. According to a 2017 Merics report, the EU attracted €35 billion in completed Chinese FDI transactions in 2016, corresponding to a 77 % increase compared to 2015 levels. Chinese data for 2016 put Chinese global non-financial FDI at about €158 billion, and Chinese financial FDI at €9 billion (Baker McKenzie sets total Chinese FDI at €185 billion). EU FDI to China, by contrast, continued to decrease to €8 billion, down from €9.1 billion in 2015 and €11.8 billion in 2014. To put the 2016 data for Chinese FDI inflows into the EU into perspective, in 2015 the EU was the destination of €467 billion of global FDI. Hence, Chinese FDI still accounts for a small share of total FDI inflows into the EU. As for the prospects for 2017, China's tightening of capital controls in late 2016 due to massive capital flight, together with a perceived less welcoming investment climate for Chinese investors, are likely to curb Chinese FDI inflows into the EU. Overall, current bilateral FDI flows have huge untapped potential.

Geographical distribution

During the past decade, Chinese FDI in the EU has remained fairly concentrated on France, Germany and the UK (see Figure 2). The considerable variation between the different EU regions stems from the fact that large individual transactions, such as the Chinese takeover of Volvo in 2010 and Pirelli in 2015, tend to distort statistical data, given the comparatively low level of Chinese FDI flowing into the remaining 25 Member States at present. Such variations do not necessarily reflect a new trend or investment pattern.

Figure 2 – Chinese FDI by groups of countries, EU-28, 2008-2016 (%)

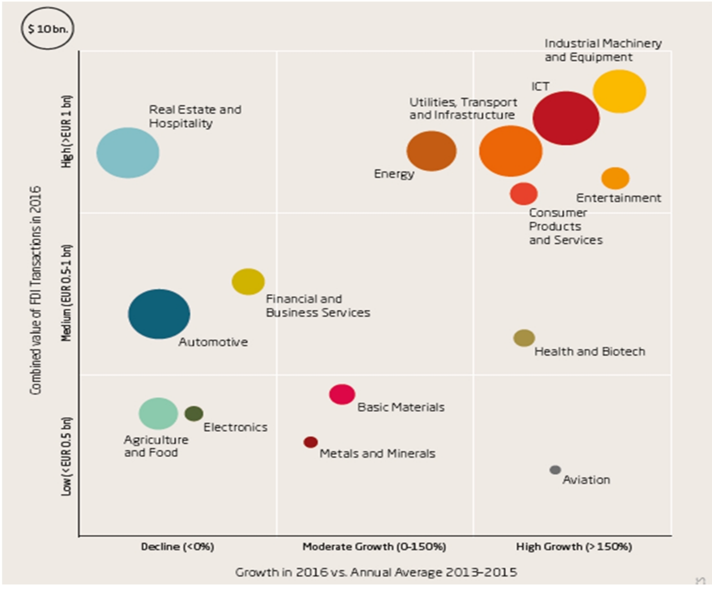


Data source: Record flows and growing imbalances, Merics, 2017, p. 9.

Sectoral distribution

Although Chinese FDI covers a vast array of economic sectors (see Figure 3), a clear focus has been set on advanced industrial machinery and equipment, ICT, utilities, transport and infrastructure, and energy. Chinese FDI in sectors such as real estate and entertainment is likely to decline in 2017, having recently been qualified by the Chinese authorities as '[irrational investment activities]' that are at odds with national strategic priorities.

Figure 3 – Chinese FDI by industrial sector, 2008-2016, (US$ billion)



Data source: Record flows and growing imbalances, Merics, 2017, p. 7.

Emerging new challenges?

In 2016, various Chinese transactions came under scrutiny in a number of Member States as a result not only of security but also of economic concerns, sparked by the dramatic surge in Chinese acquisitions of EU firms and the considerable value of some of these transactions. The sensitive nature of the high-tech sectors (for example dual-use semi-conductors) that had been targeted raised concerns about national security. From an economic perspective, some transactions have given rise to concerns about the future global competitiveness of EU business being jeopardised through the outflow of advanced technologies in strategic sectors. Added to this was speculation made about some of these transactions being backed by Chinese state funding in pursuit of industrial policies, resulting in 'unfair competition'.

The new concerns about unfair competition from China through what has been termed as 'bids that cross between private investment and state-orchestrated takeovers', have added to long-standing worries about the persistent lack of reciprocal access for EU companies to the Chinese market. While numerous sectors are prohibited or restricted to EU firms in China, they are entirely open to Chinese firms in the EU. Therefore a debate has emerged about the need for reinforcing FDI scrutiny mechanisms at Member-State level or creating a new EU-wide FDI screening mechanism.

China-specific concerns about security and unfair competition are to a large extent related to the particularities of the Chinese political economy, where state interference prevails over market forces, and the lines between the public and the private sector are blurred. Chinese FDI flowing into the EU therefore tends to arouse more suspicion over a hidden political agenda than previous waves of FDI from Japan, South Korea and the USA, all recognised democracies, functioning market economies and military allies. China's authoritarian one-party state, by contrast, appears to be an outlier with significant economic leverage, which promotes principles and norms that are frequently at odds with those of Western liberal democracies, including the rule of law, transparency and fair competition. China has a record of poor oversight of its export control rules, of political and economic espionage,[3] and of insufficient protection of intellectual property rights. Moreover, it has the reputation of aiding the proliferation of sensitive technologies to 'rogue states', such as North Korea.

Against this background, security concerns related to Chinese FDI may arise in respect of 1) control over strategic assets, such as nuclear power plants; 2) control over the production of critical defence inputs (such as military semi-conductors); 3) transfer of sensitive technology or know-how to a foreign country whose hostile intent cannot be excluded; and 4) espionage, sabotage, or other actions of a disruptive nature. Currently, Member States may address security concerns through FDI reviews.

FDI screening on national security grounds inside the EU

While there is no systematic centralised FDI screening on security grounds at EU level, almost half of EU Member States operate national security reviews.

FDI scrutiny at EU level is carried out under EU competition rules (notably the EU Merger Regulation) based on Article 101 of the Treaty on the Functioning of the European Union (TFEU), which prohibits cartels and anti-competitive agreements, and Article 102 TFEU, which prohibits the abuse of a dominant position. It focuses on screening mergers and acquisitions for their ensuing economic power in the relevant market, so as to ensure fair and undistorted competition in the EU's internal market. However, it does not consider the source of funding for the transactions being reviewed. The enforcement of the EU Merger Regulation is shared between the European Commission and the Member States' anti-trust authorities, as defined in EU law (the division is mainly based on turnover thresholds).

Legal basis for FDI security reviews at Member-State level

EU Member States' national security reviews are based on either or both of the following legal bases: 1) Article 346(1)(b) TFEU, which excludes the national defence sector, and hence measures which the Member States consider necessary for the protection of essential interests of their security, from the application of the EU Treaties, and 2) Article 65(1)(b) TFEU, as a derogation from the fundamental principle of free movement of capital and payments as enshrined in Articles 63-66 TFEU.

Unlike the other three freedoms of the internal market, involving the free movement of persons (including the free movement of workers and the freedom of establishment), goods, and services, the free movement of capital extends to third countries as well. Article 63(1) TFEU provides that: 'all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited'. Exceptions from its broad scope have been interpreted narrowly by the Court of Justice of the European Union (CJEU) in its settled case law, notably in the case law on Member States' 'golden share' arrangements (special shares held by some EU Member States in privatised former state-owned enterprises).

There are two possibilities for EU Member States to restrict the free movement of capital: 1) by invoking grounds of public policy or public security explicitly mentioned in Article 65(1)(b) TFEU, which, however, may not constitute 'a means of arbitrary discrimination or a disguised restriction of this freedom', and 2) by invoking over-riding reasons relating to the general interest (environmental protection, town and country planning, and consumer protection), as recognised by the CJEU.

Member States cannot unilaterally determine the scope of public security without any control by the EU institutions. They may rely on the public security exception only in the presence of a 'genuine and sufficiently serious threat' to a fundamental interest of society. This exception must not be applied for purely economic ends; investors must have an opportunity to challenge the decision before a court. Restrictive measures must satisfy the proportionality test; that is, they must be necessary to achieve the objectives and there must be no less restrictive measure that is equally effective.[4] The CJEU has recognised a few strategic sectors, such as oil, telecommunications and electricity, as vulnerable in this regard, but has significantly limited Member States' discretion.[5]

FDI security-related screening procedures at Member-State level

Table – 1 FDI security-related screening procedures at Member-State level

Country	Market access	FDI scrutiny procedure	FDI scrutiny practice		Sectors of FDI reviews/limitations	
	limitations or prohibitions	formal or informal	case-by-case scrutiny	automatic scrutiny	only defence	defence and/or other sectors
Belgium	✓(2015)	no	n/a	n/a	no	✓maritime transport
Bulgaria	no	no	no	no	no	no
Czech Republic	✓(2015)	no	n/a	n/a	no	✓banking, insurance and defence sectors
Denmark	✓	✓	no	✓	✓	✓electricity and gas infrastructure
Germany	no	✓	✓	no	no	✓
Estonia	no	no	no	no	no	no
Ireland	✓	no	n/a	n/a	✓	no
Greece	✓(2015)	no	n/a	n/a	no	✓land
Spain	✓	✓	✓(non-defence)	✓ (defence)	no	✓
France	✓(2015)	✓	no	✓	no	✓
Croatia	✓(2016)	no	no	no	no	✓maritime transport, rail transport, etc.
Italy	✓(2015)	✓	✓	no	no	✓
Cyprus	✓(2015)	no	n/a	n/a	no	✓energy, TV/radio, etc.
Latvia	✓(2015)	✓(no legal framework	✓(recently: energy, transport)	no	no	✓land
Lithuania	✓	✓	no	✓	no	✓
Luxembourg	no	no	no	no	no	no
Hungary	✓(2015)	no	no	no	no	✓farmland, defence industries, etc.
Malta	no	no	no	no	no	no
Netherlands	✓(2015)	✓(no legal framework)*	n/a	n/a	no	✓transport, energy, defence and security, etc.
Austria	✓(2015)	✓	no	✓	no	✓
Poland	✓	✓	no	✓	no	✓
Portugal	✓(2015)	✓	✓	no	no	✓
Romania	n/a	✓Supreme Defence Council, no action yet (2015)	n/a	n/a	no	✓
Slovenia	✓(2015)	no	no	✓	✓	no
Slovakia	no	✓(no legal framework (2016)	✓	no	no	✓
Finland	n/a	✓	✓(non-defence)	✓ (defence)	no	✓
Sweden	✓	no	no	no	✓	no
United Kingdom	✓	✓	✓	no	no	✓

Source: Author's compilation based on responses from EU Member State agencies to EPRS enquiries as of January 2017 and partly relying on the categories set out in the 2016 OECD report on Investment Policies Related to National Security. The US Government's Investment Climate Statements were also consulted: the year in brackets indicates the edition *A programme of sector-specific risk analyses was found as the basis for reviews and future legislative action.

Table 1 describes Member States' approaches to vetting FDI on national security, public policy or public security grounds. These approaches vary considerably and may include i) complete absence of FDI reviews, ii) reviews based on a formal procedure or iii) case-by-case reviews without a legal framework.

The majority of Member States either have a legal framework for scrutiny in place or have performed case-by-case reviews for security reasons. There could be reviews due to partial or total prohibitions of, or restrictions on, FDI in specified sectors, such as in Ireland which has no formal screening mechanism, but prohibits foreign (and domestic) investment in the arms sector. Denmark, for example, both has a formal scrutiny procedure and excludes FDI from its gas and electricity infrastructure, which must remain public property. In some cases partial restrictions of foreign ownership concern real estate or land (for example Greece or Latvia).

FDI screening in most Member States is carried out in a broad range of sectors other than defence. Those Member States embracing a narrow interpretation of national security (limited to the weapons industry), such as Denmark, Sweden, and Slovenia, have introduced restrictions under a specific legal basis. The prevailing approach uses case-by-case scrutiny, while automatic scrutiny is mostly linked to the requirement to hold a licence for a commercial activity, such as the production of weapons; in Spain and Sweden, screening is mandatory for the defence sector, while it is run case-by-case for other sectors.

A distinction may also be made between Member States that operate reviews for pre-defined sectors and those that also run cross-sectoral reviews. The German FDI screening mechanism, for example, has two pillars: sector-specific scrutiny applicable to all acquisitions of firms manufacturing or developing war weapons or armaments, or producing cryptographic equipment, and cross-sector scrutiny that may be triggered by the acquisition of more than 25 % of voting rights in the company to be acquired, although the latter is only applied to investments from non-EU and non-European Free Trade Association (EFTA) countries.

In recent years, several Member States (Finland, France, Italy, Poland and Portugal) have revised their FDI screening procedures. In 2009, Germany added a cross-sector scrutiny component to its defence-sector scrutiny procedure. So far, Member States have in general made moderate use of their FDI security-screening procedures. Notwithstanding this, it may be argued that, as long as such procedures are not coordinated at EU level or are entirely lacking in some cases, this may undermine their implementation where they exist, and prevent Member States from leveraging their collective bargaining power.

Member States' FDI security-related screening procedures in practice

In 2016, some proposed takeovers of cutting-edge technology firms from the EU by Chinese private firms or funds, as well as investments made by Chinese state-owned enterprises (SOEs) in sensitive strategic sectors, encountered opposition in a number of Member States (see Table 2 below). The second example illustrates the UK government's concerns about Chinese SOEs gaining a majority stake in nuclear power plants in the future, and its intention to introduce a new legal framework for FDI in critical infrastructure. A warning from the Belgian security services (VSSE) about security threats involving one of the biggest Chinese SOEs, State Grid, has exposed the difficult task facing Member State policy-makers of having to strike a balance between the economic advantages of Chinese FDI and the political and security challenges it may entail. As becomes evident from the first, third and fifth cases described in the next section, decisions by the Australian and US FDI screening bodies played a major role in the withdrawal of Chinese acquisition proposals. This creates a considerable degree of unpredictability for foreign investors in the EU.

In Germany, certain Chinese transactions have raised concerns about the role that the Chinese government's industrial policies may have played. They have also sparked a controversial debate between those wondering how foreign state influence in FDI transactions can be better traced and prevented from distorting fair competition on European markets, and those sceptical about or disapproving of a potential tightening of FDI screening, pointing at the adverse economic impact this would have.

Table 2 – Proposed Chinese acquisitions of EU firms delayed or withdrawn, 2016

Targeted asset	Sector of asset	Chinese involvement	Member-State involvement	State security agency or foreign influence	Outcome
Philips Lumileds (NL), based in the USA	auto-motive lighting, dual-use issue	80 % stake; GO Scale Capital	no involvement of the Dutch government	The USA blocked the sale of Lumileds' US assets on national-security grounds	withdrawal of acquisition by investor
Hinkley Point C (UK) EC file	nuclear power plant	33.5 % share; China General Nuclear (CGN) (SOE)	decision by the May government to scrutinise an agreement concluded by the former Cameron government	not known, but later a related industrial espionage case emerged in the USA	approval with 'golden share' arrangement, that is, an increase of CGN's ownership share requires government approval and for other nuclear plants to be built with Chinese technology
Eandis (BE)	gas and electricity grid	14 % share; Chinese State Grid (SOE)	no government decision, but Flemish energy minister reversed his opinion following a warning by the VSSE	warning by the VSSE after Australia blocked State Grid takeover on national security grounds	vote by Eandis owners (Flemish local cities and councils) against takeover after internal tariff disagreements unrelated to the Chinese bid
Osram's light bulb unit Ledvance (DE)	lighting and LED chips	100 % takeover; Chipmaker Sanan Optoelectronics and GSR Go Scale Capital Advisors	the German government turned down a Chinese request for approval pending a review of the deal	not known	withdrawal of proposed acquisition by investor; additional factor: staff opposition; meanwhile Ledvance was acquired by Chinese MLS Co. Ltd
Aixtron (DE)	semi-conductor dual-use issue	100 % takeover; Fujian Grand Chip Investment Fund LP (FGC)	withdrawal of the clearance certificate granted by the German government	The USA blocked the sale of Aixtron's US assets on national security grounds	takeover bid withdrawn by investor

Source: Author's compilation based on press coverage referenced by links in the table.

FDI screening mechanisms outside the EU

Australia, Canada, Japan and the USA have long-established statutory FDI screening procedures.[6] The Committee on Foreign Investment in the United States (CFIUS) is the most widely known, sophisticated and active body applying such a mechanism. It partly served as a model for Japan and most recently for China, the latter having allegedly set up its counterpart in the wake of negative CFIUS reviews of Chinese deals.

All FDI screening mechanisms operate on a broad security concept that is not limited to the national defence sector but encompasses a variable number of sensitive sectors, such as critical infrastructure and technologies. Australia's 'national interest test' and Canada's 'net benefit test' go even further. The 'Three Threat' framework applied by CFIUS may be seen as a comparatively narrow approach limited to genuine security threats and excluding issues of perceived 'unfair competition', despite pressure to include them.

Table 3 – Key aspects of FDI screening on security grounds in major economies

	Australia	Canada	China	Japan	United States
Main legal basis	1975 Foreign Acquisitions and Takeovers Act (FATA)	1985 Investment Canada Act (ICA), Part IV.1, Investments Injurious to National Security	2015 National Security Law (NSL) based on rules existing since 2011	1949 Foreign Exchange and Foreign Trade Act (FEFTA)	1950 Defense Production Act, 1988 Exon-Florio Amendment, 2007 Foreign Investment and National Security Act (FINSA)
recent amendments	2015 and 2015 Foreign Acquisitions and Takeovers Regulation (FATR)	2013 Bill C-60 tightened guidelines on SOEs		2007 introduced designated industries	2009 CFIUS regulations left definition of threat to national security open-ended
specific body in charge	Foreign Investment Review Board (FIRB); supportive of Treasurer	no, case-by-case involvement of other ministries	Ministry of Commerce (Mofcom) and National Development and Reform Commission (NDRC) and other ministries	no, case-by-case involvement of other ministries and an advisory body	1975 Committee on Foreign Investment in the United States (CFIUS) chaired by the Secretary of the Treasury
leading role/final decision	Treasurer (finance minister)	Governor in Council	Mofcom and NDRC	Minister of Finance	CFIUS, but US President has final veto
concept underlying the screening	national interest test	national security test, net benefit test, cultural heritage test	a broad range of security aspects, including economic security	public order, public safety and national security	national security including critical infrastructure and critical technologies
SOE-specific test	yes	SOE guidelines	no	not mentioned in the FEFTA	mandatory since the 1992 Byrd Amendment
thresholds	20 % in general; other thresholds for agribusiness, land, etc.	each test has its own rules, yet there is no threshold for national security	50 % in sensitive sectors	over 10 % in listed firms in defined industries	no
mandatory or voluntary nature of notification	mandatory if threshold and sector covered	voluntary	voluntary notification, so far sporadic use	Japan pre-notification mandatory in defined sectors, no thresholds	voluntary notification, but CFIUS watches out for non-filers
judicial review	no	no	no	yes	no

Source: Author's compilation based on academic articles referenced by links in the table and the 2016 OECD report on Investment Policies Related to National Security.

In all jurisdictions, there is a notable lack of statutory definitions for the core concepts. This may result in significant discretion for the decision-making body, but in considerable uncertainty for economic operators. Unpredictability may arise from the risk of ex-post mitigation measures or even divestment in FDI screening mechanisms based on voluntary notifications, thus challenging property rights. Determinations are not final, but CFIUS or the Canadian regulator may retroactively unwind acquisitions, if mitigation measures have not been complied with. There is also the possibility for domestic firms to use the review procedures to disadvantage foreign competitors.[7]

Despite CFIUS' obligation to report to the US Congress, the opacity of its operations has drawn considerable criticism. With the exception of Japan, regulators' decisions in the other jurisdictions examined are not open to judicial review. However, the first-ever court case against CFIUS brought by Chinese Ralls Corporation after then US President Barack Obama in 2012 ordered the divesture of the firm's acquisition of four wind-farm projects located next to a restricted military facility used for testing drones, has challenged CFIUS decisions as a non-justiciable matter. Moreover, it appears to have improved the transparency of CFIUS procedures to some degree.

In all the jurisdictions examined, outright rejection of foreign acquisitions is extremely rare, since all the mechanisms provide for negotiations on mitigation arrangements which may lead either to approval or withdrawal. Australia reported three rejections in 2009-2010, Canada three in 2009-2016, Japan only one in 2008 and, according to the 2014 CFIUS report (the most recent available data), the USA made one rejection in 2009-2014. A trend towards further tightening of FDI scrutiny, particularly as regards Chinese SOEs, is obvious in most of the jurisdictions examined here. In late 2016 for example, the US-China Economic and Security Review Commission recommended that the USA consider expanding the power of CFIUS to bar Chinese SOEs from acquiring or otherwise gaining effective control of US companies.

China's review mechanism, which is also included in its 2015 draft Foreign Investment Law, is the most recent. While showing some formal overlap with the US model, it is embedded in a very different regulatory environment. It adds an additional layer of regulatory control to an already highly bureaucratic and restrictive inbound FDI screening system, which guides FDI into specific sectors in line with government-defined industrial-policy goals. It creates a new investment barrier with a high degree of vagueness and discretion for decision-makers and less certainty for foreign investors. Given its broad scope, it remains to be seen to what extent it may cancel out the positive market access effects the future EU-China comprehensive investment agreement is expected to have.

Contrary to these mechanisms, EU law would require a potential EU-wide FDI screening mechanism, among other things, to be based on the principles of non-discrimination, transparency, access to justice and clearly defined concepts underpinning legal certainty. However, the creation of an EU-wide mechanism may result in a loss of the EU's comparative advantage over its OECD peers as an open market for FDI (as measured by the OECD FDI regulatory restrictiveness index), which is a key principle of EU economic diplomacy.

Without a new EU FDI scrutiny mechanism, the restrictive FDI screening in other OECD economies is likely to further strengthen the EU's reputation as a welcoming FDI destination and thus attract more Chinese FDI. However, the lack of EU policy coherence for inbound FDI, which such a mechanism could address, may also become a burden for the EU's relationship with the USA, given the two entities' close corporateinvestment ties and especially if US security interests are affected by foreign takeovers of EU firms producing military material for the USA.

EU business and academic views

EU business views

In 2008, Business Europe advocated acting 'on facts rather than fear', stressing that 'evidence of politically motivated investments ... is not convincing'. It expressed scepticism about both the legal feasibility and the actual need for additional FDI screening mechanisms, calling for proportionate responses, less fragmentation and more transparent and predictable rules. Conversely, in February 2017, the president of the European Chamber of Commerce in China, Jörg Wuttke, lobbied for a unified vetting mechanism of inbound Chinese FDI at EU level at a webstreamed meeting of the EP's Committee on International Trade (INTA) monitoring group on China.

Academic views

Academics have criticised the EU's fragmented regulatory approach, and have advocated better coordination of national policies based on a common legal framework. Some experts have stressed that positive reciprocity (return favours) rather than negative reciprocity (return harm) should be privileged. This would imply that FDI screening must be limited to national security considerations, and that it must exclude economic security issues. Some academics have stressed that a transparent EU-wide mechanism would provide certainty for investors and eliminate inconsistencies arising from the current patchwork system. Some experts hold the view that a common review system would allow the identification of sectors that are vital for EU security, and where the concentration of economic power by non-EU investors risks being used for political goals.

Outlook

The emerging debate recalls earlier discussion on creating an EU-wide FDI screening mechanism. In the 2008 debate on sovereign wealth funds, the European Commission dismissed the idea as 'sending a misleading signal that the EU is stepping back from its commitment to an open investment regime'. In 2011, a debate about the introduction of a CFIUS-style mechanism at EU level and the harmonisation of existing norms at Member-State level was triggered by the attempted takeover of Dutch cable-maker Draka by the Chinese company Xinmao, through a bid perceived as suspiciously high.

European Parliament position

In a resolution of 23 May 2012 on EU and China: Unbalanced Trade?, the European Parliament called on the European Commission and the Member States 'to set up a body entrusted with the ex-ante evaluation of foreign strategic investment, along the lines of the Committee on Foreign Investment in the United States (CFIUS), in order to obtain a clear picture of businesses operating and investing in the territory of the EU'. In a resolution of 9 October 2013 on EU-China negotiations for a bilateral investment agreement, the European Parliament recalled 'that a security review mechanism to scrutinise foreign investments was recently set up in China and that the use of such mechanisms by both parties may be based on legitimate grounds'. It pointed out 'that the EU and China may have legitimate security concerns that justify total or partial exclusion of some sectors from foreign investment on a temporary or long-term basis'.

In July 2016, a strategic note on Engaging China at a Time of Transition, published by the European Commission's European Political Strategy Centre, advocated a 'more coordinated approach or even a common European review mechanism'. It argues that a clear and effective European review mechanism for all non-EU FDI in security-related areas may contribute to defending the EU's current openness to FDI against a protectionist backlash. It states that the potential risks to EU security as a result of growing Chinese FDI in assets with cross-border security implications, could overwhelm the capability of smaller countries to review transactions in an appropriate manner. In its reflection paper on Harnessing Globalisation of May 2017, the European Commission raises concerns about 'foreign investors, notably state-owned enterprises, taking over European companies with key technologies for strategic reasons.' It states 'EU investors often do not enjoy the same rights to invest in the country from which the investment originates. These concerns need careful analysis and appropriate action.'

Further reading

CFIUS and National Security: Challenges for the United States, Opportunities for the European Union, Th. H. Moran, Peterson Institute for International Economics (PIIE), February 2017.

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Endnotes

[1] Merics data rely on a 'bottom-up' method and a more up-to-date dataset collected by Rhodium Group, which takes into account media reports, professional deal databases and regulatory filings. It covers greenfield projects and acquisitions that exceed 10 % of voting rights. This is an alternative to methods used by national ministries which feed into international and EU FDI statistics that are published with a considerable delay. Particularly in the case of China, the accuracy of official data is affected by discrepancies between national agencies regarding financial and non-financial transactions, measurement errors, the omission of indirect holdings and under-reporting of the final destination of Chinese FDI resulting from the intensive use of offshore financial centres by Chinese firms.

[2] Chinese Outbound Investment in the European Union, European Chamber of Commerce in China, 2013, pp. 26-28.

[3] China invests in Europe. Patterns, Impacts and Policy Implications, Th. Hanemann and D. H. Rosen, Rhodium Group, June 2012, pp. 60-61.

[4] C-54/99 Scientology Church, paragraphs 17 and 18; C–483/99 Commission v France, paragraph 48; C–503/99 Commission v Belgium, paragraph 47, C-463/00 Commission v. Spain, paragraph 72.

[5] The CJEU has so far only approved the Belgian model in C–503/99 Commission v Belgium, paragraphs 46-55.

[6] Foreign Investment, the National Interest and National Security – Foreign Direct Investment in Australia and China, V. Bath, Sydney Law Review, Vol. 34(5), 2012, pp. 5-34; Chinese Investment in the United States and Canada, M. Klaver and M. Trebilcock, The Canadian Business Law Journal, Vol. 54(2), September 2013, pp. 123-177; National Security Review in Foreign Investments: A Comparative and Critical Assessment on China and U.S. Laws and Practices, X. Li, Berkeley Business Law Journal, Vol. 13(1), August 2016, pp. 255-311.

[7] Transparency and Predictability for Investment Policies Addressing National Security Concerns, A Survey of Practices, OECD, 2008, p. 20.

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