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Lost in translation? The Comprehensive Agreement on Investment and EU–China trade relations

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Table of contents

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This Discussion Paper is a joint EPC–Egmont publication, part of a broader partnership that focuses on exchanging expertise and analysis on EU affairs and the EU's role in the world.

List of abbreviations

AB	World Trade Organization Appellate Body
BIT	bilateral investment treaty
CAI	Comprehensive Agreement on Investment
DSB	World Trade Organization Dispute Settlement Body
DSM	dispute settlement mechanism
FDI	foreign direct investment
FTA	free trade agreement
FTT	forced technology transfer
GATS	General Agreement on Trade in Services
GPA	World Trade Organization Agreement on Government Procurement
ICS	Investment Court System
ILO	International Labour Organization
IPI	International Procurement Instrument
IPR	intellectual property rights
ISD	Investment and Sustainable Development
ISDS	investor-state dispute settlement
JV	joint venture
LPF	level playing field
MC12	12th World Trade Organization Ministerial Conference
MEP	Member of the European Parliament
MFN	most favoured nation
MIC	Multilateral Investment Court
PP	public procurement
R&D	research and development
SOE	state-owned enterprise
TSD	Trade and Sustainable Development
UNCITRAL	United Nations Commission on International Trade Law
WTO	World Trade Organization

Executive summary

After seven years in the making, the EU and China finally reached an 'agreement in principle' on the ambitious Comprehensive Agreement on Investment (CAI) on 30 December 2020. According to the European Commission, this is "the most ambitious agreement that China has ever concluded with a third country." However, EU–China relations since plummeted due to sanctions and countersanctions over human rights issues. The European Commission and Parliament have put the agreement on ice, although its technical preparation and translation are still ongoing. It is improbable that the agreement will enter into force anytime soon. Nevertheless, considering the economic and geopolitical importance of the EU–China trade and investment relationship, this agreement deserves to be discussed in detail.

This Discussion Paper analyses the scope and contents of the CAI and explores the main challenges and opportunities for EU–China trade and investment relations. It first dissects and discusses the key features of the CAI: provisions on market access and investment liberalisation, the level playing field, sustainable development, the institutional framework, and dispute settlement. Secondly, the CAI's broader legal and political context is analysed, focusing on its lack of investor protection provisions, its potential to contribute to the World Trade Organization (WTO) reform process, and its role in the triangular EU–US–China trade and investment relationship. Thirdly, the CAI's link with the EU's new autonomous trade tools, sustainability and human rights dimension, and prospects for signature and ratification are studied.

The CAI is not a revolutionary agreement that will break open the Chinese market for EU investors. China's market access commitments in the agreement mainly reflect its recent or planned unilateral foreign investment liberalisation and only provide modest new market openings. However, this does not mean that the CAI has no added value, as it enshrines China's unilateral liberalisation of foreign investment in an international treaty and can serve as a modest starting point for more ambitious rules at the bi- or multilateral (WTO) level.

Whether the CAI would make a significant difference for EU investors will mainly depend on China's implementation. Although its last Foreign Investment Law liberalised foreign investment further in several sectors, its recent adoption of a series of investment(-related) laws and policies targeting or restricting foreign investment does not bode well.

Regardless of whether the CAI will eventually be signed and ratified, the EU must continue to roll out and implement its autonomous trade tools to address China's trade-distortive practices. It must also use its (new) trade defence and enforcement tools when necessary. Moreover, it must prioritise transatlantic cooperation on WTO reform, proposing new rules that address the concerns vis-à-vis China it shares with the US and other like-minded countries.

As long as China's countersanctions against EU officials and entities are in place, the agreement should not be signed and ratified. However, if these diplomatic tensions cool down, the EU must fully leverage the CAI and its trade and investment powers more generally to address the human rights and forced labour issues in China.

Introduction

After seven years in the making, the EU and China finally reached an 'agreement in principle' on the Comprehensive Agreement on Investment (CAI) on 30 December 2020. According to the European Commission, this is "the most ambitious agreement that China has ever concluded with a third country."[1] However, since then, EU–China relations plummeted due to sanctions and countersanctions over human rights issues. The Commission and European Parliament have put the agreement on ice, but its technical preparation and translation are still ongoing. It is improbable that the agreement will enter into force anytime soon. However, considering the economic and geopolitical importance of the EU–China trade and investment relationship, the CAI deserves to be discussed in detail.

The European Commission and Parliament have put the CAI on ice, but its technical preparation and translation are still ongoing.

According to the European Commission, the CAI rebalances market access and binds China's autonomous liberalisation of investment since it joined the World Trade Organization (WTO), thereby preventing backsliding. The Commission stressed that China agrees to new market access commitments in several service sectors. Finally, it claims that the CAI strengthens the level playing field (LPF) with new rules on state-owned enterprises (SOEs), subsidy transparency and forced technology transfers (FTTs), and includes important commitments to sustainable development.

The EU's cumulative foreign direct investment (FDI) flow to China in the past two decades was around €148 billion, whereas China's FDI flow to the EU was around €117 billion. Considering the size of the Chinese market and the significance of the bilateral trade volume – China is the EU's largest source of imports, third-largest trade partner, and third destination for EU exports after the US and UK –, these investment flows are relatively underdeveloped. While the stock of Chinese FDI in the EU has grown between 2008 and 2017 – EU FDI in China grew from €54 billion to €178 billion; an increase of 225% –, it remains relatively small.[2]

A reason why EU FDI flows to China are relatively low is China's restrictive FDI framework. Whereas the EU is open to FDI, foreign investors in China face significant restrictions, especially in service sectors. The EU's 2019 EU-China Strategic Outlook, which labelled China as a key partner for cooperation but also a "systemic rival" and a "strategic competitor", highlighted how China's protectionist measures benefit its industrial champions. The measures shield them from competition through selective market opening, licensing and other investment restrictions; heavy subsidies to both SOEs and private sector companies; closure of its procurement market; localisation requirements; and the favouring of domestic operators.[3] Given this imbalance, the European Commission negotiated the CAI to improve the situation of its companies that (seek to) operate in China.

However, as soon as the CAI was announced, it was immediately criticised for three essential reasons. First, the agreement arguably provides little new market access in China, as it mainly codifies China's recent unilateral investment liberalisation efforts. Second, the CAI is critiqued as not addressing China's human rights abuses, such as the forced labour conditions of the Muslim Uyghur minority in the western region of Xinjiang, more strongly. Third, the Commission pushed the agreement through without consulting with the new Biden administration first, mainly due to Germany's desire to finish its EU Presidency with diplomatic success. This has been raised as a missed opportunity to form a united transatlantic front against China. In the meantime, the CAI is even more in limbo following the EU's and China's respective sanctions and countersanctions over human rights issues (i.e. the latter's treatment of the Uyghur minority) in March 2021.

Although the future of the CAI is highly uncertain, it remains a novelty in EU trade and investment policy. This *sui generis* agreement is not a traditional, 'new-generation' EU free trade agreement (FTA), as it does not liberalise trade in goods and services (with a few notable exceptions for services). Nor does it include disciplines on non-tariff barriers, public procurement (PP) or intellectual property rights (IPR). It is not an investment agreement in the traditional sense, as it does not provide post-admission investment protection standards (e.g. fair and equitable treatment and protection against expropriation). Neither is it an investor-state dispute settlement (ISDS) procedure, despite the EU initially envisaging it as such.

This Discussion Paper analyses the scope and contents of the CAI and explores the main challenges and opportunities for EU–China trade and investment relations. It first dissects and discusses the key features of the CAI: provisions on market access and investment liberalisation, the LPF, sustainable development, the institutional framework, and dispute settlement. Secondly, the CAI's broader legal and political context is analysed, focusing on its lack of investor protection provisions, its potential to contribute to the WTO reform process, and its role in the triangular EU–US–China trade and investment relationship. Thirdly, the CAI's link with the EU's new autonomous trade tools, sustainability and human rights dimension, and prospects for signature and ratification are studied.

1. Unpacking the Comprehensive Agreement on Investment

1.1. MARKET ACCESS AND INVESTMENT LIBERALISATION

Before turning to the CAI, it first must be noted that China has recently made selective reforms and sector-specific market openings based on its Foreign Investment Laws (FILs). China's last FIL, in force since 1 January 2020, marked an improvement because it shortened the 'negative list' of protected sectors in which foreign investment is restricted or prohibited.[4] This means that, unless they fall within the sectors listed in the negative list, the latest FIL guarantees foreign investors and their investments in China with national treatment and equal protection in their establishment and operation in China. The liberalised sectors include oil and gas, resource management, and trading and financial services. The FIL removes joint venture (JV) requirements for certain sectors and prohibits (in principle) FTTs as a precondition for investment. The implementing rules for the FIL emphasise the equal treatment of domestic and foreign-invested firms with regard to land supply, government procurement, licensing formalities and protecting intellectual property. The CAI binds this unilateral investment liberalisation and prevents backsliding to a large extent, while also creating some new market openings beyond China's autonomous liberalisation.

Section II of the CAI, "Liberalisation of Investment", includes obligations on market access, national treatment and most-favoured-nation (MFN) treatment. It also contains a list of prohibited 'performance requirements'. One Party cannot impose these conditions on investors from the other Party in their territory, such as export obligations, obligations to buy local content, FTTs, or research and development (R&D) targets. Nationality requirements concerning 'senior management and board of directors' are also prohibited. Some sectors are excluded from the CAI, such as audiovisual services, air transport services and PP. With regard to the entry and temporary stay of natural persons for business purposes (i.e. Mode 4 services of the General Agreement on Trade and Services), they are allowed to stay up to 90 days in a 12-month period for establishment purposes (and up to 3 years for managers and specialists) without restrictions (e.g. labour market tests, quotas).

China has recently made selective reforms and sector-specific market openings based on its Foreign Investment Laws.

Containing both Parties' specific commitments and reservations, the CAI's annexed schedules employ a *hybrid* approach. The CAI contains a *negative* listing for liberalisation commitments (i.e. national and MFN treatment, performance requirements). This means that the EU and China commit not to discriminate across the covered sectors (e.g. not impose JV requirements or nationality requirements) unless a specific reservation is included in the corresponding schedule. This implies that, in principle, new or future types of services will automatically be covered by the agreement. However, China's Annex explicitly mentions that it reserves the right to impose investment restrictions on 'new' industries that the document does not cover.

The binding of the liberalisation commitments is dynamic (i.e. 'ratcheting'), which means that any future relaxation of the restrictive measures included in the schedules will be automatically bound. For market access commitments (i.e. the obligation to not impose quantitative restrictions; e.g. limiting the number of licenses or branches, reserving monopoly rights, imposing economic needs test), the listing is *positive*. This means that both Parties' commit not to impose quantitative restrictions, only to the extent that the given sectors and the level of commitments are included in the relevant annexed schedules.

The CAI binds several of China's unilateral liberalisation commitments in the manufacturing sector, which makes up more than half of the EU's investment in China.

The CAI binds several of China's unilateral liberalisation commitments in the **manufacturing sector**, which makes up more than half of the EU's investment in China (i.e. 28% automotive sector, 22% basic materials). Annex III on China's market access commitments and reservations illustrates that around 30 manufacturing sectors are being liberalised, most of them without any reservations like JV or ownership requirements. These sectors include furniture manufacturing, rubber and plastic products, electrical machinery and equipment, computer and communication equipment, food processing, apparel and textiles, chemicals, and so on. Reservations only apply to around 10 strategic sectors, reflecting the foreign investment restrictions enshrined in China's recent FIL. For example, it is still prohibited for foreign firms to increase the production capacity of Chinese sectors characterised by overproduction (e.g. cement, steel, (non-ferrous) metals, aluminium, transport equipment). In other words, EU companies can still invest in these sectors by, for example, acquiring a Chinese enterprise but not increase the overall production capacity.

Several reservations apply to the **automotive sector**, which represents almost 30% of EU FDI in China. The CAI illustrates China's ambition to promote the production of electric vehicles. It stipulates that the establishment of "new traditional fuel-powered motor vehicle enterprises" is prohibited. Increasing this sector's production capacity is only allowed under strict conditions related to overcapacity. Instead, the CAI provides EU companies access to China's electric vehicles sector. Establishing new production capacity in electric vehicles is allowed but subject to limitations related to overcapacity and competition with "existing independent investment projects".[5] However, to intensify cooperation in electric vehicles, these limitations do not apply to investment projects in pure electric vehicles by EU investors that amount above $1 billion.[6] China will also lift several restrictions on foreign investment in this sector, such as a minimum of 50% Chinese ownership and JV requirements. This liberalisation was already foreseen in China's 2020 FIL and 'negative list'. And in line with this FIL, the CAI's reservations will only apply until 2022 – it is unlikely that the agreement will enter into force before then. This implies that EU enterprises could wholly own subsidiaries in the automotive sector, which is currently not the case (in principle). It should be mentioned, however, that some exceptions have already been made for BMW and Tesla.

The CAI illustrates China's ambition to promote the production of electric vehicles.

Regarding investment in **services**, it should first be recalled that China only made limited commitments under the General Agreement on Trade in Services (GATS) Mode 3 (commercial presence) when it joined the WTO. The real GATS-plus market opening created by the CAI can only be measured by comparing the agreement with China's commitments under the GATS. Moreover, China liberalised several of its service sectors unilaterally through successive FILs. A detailed comparison is beyond the scope of this Discussion Paper. Nevertheless, it can be observed that China is making important GATS-plus commitments in the area of services (i.e. financial, real estate, environmental, computer, construction, auxiliary air transport and international maritime transport services), particularly by lifting JV requirements. For most service sectors covered by the CAI, no reservations apply with regard to market access (Annex III), although several national treatment reservations apply in most liberalised sectors (Annex II). For example, concerning financial services, the CAI prohibits JV requirements and foreign equity caps for banking, trading securities and insurance. China has agreed to lift the investment ban from cloud services, opening it to EU investors subject to a 50% equity cap. However, EU investors are still prohibited from investing in internet access services. China will offer a new market opening in health services by lifting JV requirements for private hospitals in key Chinese cities (although the majority of the medical personnel must still hold Chinese nationality). JV requirements or Chinese control is still required in sectors like publishing and air transport. EU investors will still be (largely) prohibited from investing in sensitive sectors, such as the exploration or exploitation of raw materials, and postal services.

Most of China's market access commitments in the CAI do not create new investment opportunities for EU investors in China, as they essentially codify existing or envisaged unilateral market access commitments under its recent FILs. For instance, China has already started to remove JV requirements from the financial and health sector, allowed 50% foreign ownership in cloud services since 2019, and began liberalising investments without JVs for electric and hybrid vehicles in 2018. The value of the CAI is that it locks in these commitments. Moreover, China's commitments and openings in service sectors will benefit not only the EU but also all other WTO members by virtue of MFN rules (GATS Article II).

1.2. THE LEVEL PLAYING FIELD

The CAI aims to create a fair(er) LPF by including rules on SOEs, subsidy transparency, FTTs, and standard-setting and transparency.

1.2.1. State-owned enterprises

One of the EU's greatest concerns about China's investment and trade regime relates to the competitive distortive effects caused by its SOEs. WTO agreements do not, in principle, forbid SOEs (provided that they operate on a commercial basis), and SOEs are not covered in great detail in China's WTO accession protocol. The CAI is one of the few agreements concluded by China that covers disciplines on SOEs, although its WTO accession protocol does state that they "would make purchases and sales based solely on commercial considerations".[7] The CAI gives a precise and comprehensive definition of SOEs, covering entities where the state holds the direct or indirect power to control decisions through minority ownership and/or to appoint the management body, and state-designated monopolies or entities vested with special rights or privileges.

The EU would need to rely on China's goodwill to provide sensitive information on its state-owned enterprises.

The agreement requires SOEs to act in accordance with commercial considerations and not discriminate in their purchases and sales of goods and/or services. This implies that Chinese SOEs cannot discriminate against goods or services supplied by EU investors or favour Chinese goods and services. Notably, a footnote in the CAI specifies that this commitment does not apply to EU firms with no commercial presence in China. A specific transparency mechanism provides that the Parties may request information about a SOE of the other Party if it believes that its interests are being “adversely affected by the commercial activities” of said SOE.[8] This information can include details about the Party’s ownership and voting and management structure of the enterprise, or the latter’s annual revenue, total assets or exemptions under domestic law and regulations. There is, however, no strict obligation to *reply* to these requests, which means that the EU would need to rely on China’s goodwill to provide sensitive information on its SOEs. Moreover, there is no specific requirement to notify subsidises to (or by) SOEs, although a general notification mechanism does exist (see section 1.2.2.).

1.2.2. Subsidies

The lack of transparency and unfair competition of Chinese subsidies is another major EU concern that the CAI addresses. The agreement goes beyond WTO rules as it also includes transparency obligations for subsidies in the service sectors. Both Parties will be required to publish promptly (i.e. within the calendar year after the subsidy being granted) details of the subsidies covered by the agreement (e.g. objective, form, budget size, recipient). The CAI also obliges both Parties to engage in consultations to share additional information on subsidies that could negatively affect investment interests. The requesting Party may ask for additional information about the subsidy (e.g. the amount). However, a Party cannot be forced to remove such a subsidy. It is only obliged to “use its best endeavours to find a solution”.[9]

It remains to be seen whether these soft commitments will suffice. China’s track record on timely compliance and quality of subsidy notification is already proving to be poor. The EU and other WTO members consistently criticise China’s failure to notify its possible subsidy programmes in sectors like steel and aluminium to the WTO’s Committee on Subsidies and Countervailing Measures.[10]

China’s track record on timely compliance and quality of subsidy notification is already proving to be poor.

The CAI clearly intends to improve subsidy transparency. It does not, however, create new disciplines on prohibited subsidies. Moreover, the enforcement of its subsidy rules is weak, as disputes about these provisions are not actionable under its dispute settlement mechanism (DSM). Therefore, at best, the European Commission can use the improved notification requirements to launch anti-subsidy duties or WTO cases. Nonetheless, it appears that the EU aims to use its autonomous trade tools (e.g. its envisaged Foreign Subsidy Instrument; see section 2.5.) and multilateral negotiations on subsidies at the WTO level or from the trilateral talks with Japan and the US to address the trade-distortive effects of China’s subsidies (see section 2.2.). The CAI anticipates the possible outcome of future WTO discussions on subsidies. Depending on the progress and possible outcome of these WTO discussions, the EU and China may adopt a decision by the relevant joint committee to update these provisions.

1.2.3. Forced technology transfers

Another long-standing concern for the EU and other foreign enterprises operating in China relates to China’s FTT requirements (in the areas of e.g. electric vehicles, biotechnology). The EU already challenged these practices before the WTO, arguing that they violate China’s WTO accession protocol.[11] However, China recently prohibited FTTs in its 2020 FIL (in principle). The CAI codifies this commitment by forbidding the imposition of technology transfers, production processes or other proprietary knowledge on other Party’s investors (e.g. the requirement to transfer technology to a JV partner). The agreement also prohibits the Parties from interfering in contractual freedom of technology licencing. Similar disciplines on FTTs are included in the US–China Phase 1 trade deal.

Regarding **domestic regulation**, the CAI incorporates provisions equivalent to those currently under negotiation in the context of the plurilateral WTO Agreement on Services Domestic Regulation. The CAI provides that licensing and qualification requirements and procedures must be transparent and reasonable and prevent barriers to investment. It also states that investors from the other Party will be given equal access to standard-setting bodies – a long-standing request of EU industry. Finally, it also includes transparency rules on regulatory and administrative measures to enhance legal certainty and predictability and on procedural fairness and the right to judicial review (i.e. in competition cases). The EU and China are discussing similar rules in the WTO in the context of a plurilateral agreement on investment facilitation.

1.3. INVESTMENT AND SUSTAINABLE DEVELOPMENT

The CAI includes a chapter on “Investment and Sustainable Development” (ISD), which is similar to the EU’s standard approach to Trade and Sustainable Development (TSD) chapters in its recent FTAs.

In the areas of labour and environment, both Parties commit not to lower the standards of protection to attract investment, not to use labour and environment standards for protectionist purposes, and to respect its international obligations in the relevant treaties. It also includes a standard provision on the right to regulate, confirming that each Party remains free to determine its sustainable development policies and priorities, establish its levels of domestic labour and environmental protection, and adopt or modify its relevant laws and policies accordingly. The EU and China will support their companies' uptake of corporate social responsibility.

Importantly, the CAI also includes commitments on the environment and climate, including effectively implementing the multilateral environmental agreements to which it is a signatory (i.e. the Paris Agreement and its Nationally Determined Contributions). The EU and China shall also facilitate and encourage investment in environmental goods and services.

China also commits to effectively implement its ratified International Labour Organization (ILO) Conventions and work towards ratifying its outstanding fundamental Conventions. Regarding forced labour, China "shall make continued and sustained efforts on its own initiative to pursue ratification of the fundamental ILO Conventions No 29 and 105" (both on forced labour).[12] These commitments are important, considering the concerns of European civil society and several Members of the European Parliament (MEPs) about China's human rights abuses (e.g. forced labour conditions of the Muslim Uyghur minority; see section 2.4.).

Similar to the other TSD chapters in EU FTAs, disputes under this chapter are exempted from the general DSM (which can lead to the suspension of trade preferences in the case of non-compliance). Instead, they rely on a weaker mechanism that involves monitoring by and consultation between the Parties, and a report by a panel of experts. However, contrary to the TSD chapters in recent EU FTAs, the CAI does not provide for the involvement of civil society through Domestic Advisory Groups. Civil society organisations are only allowed to deliver, under certain conditions, unsolicited written submissions to the panel of experts (i.e. *amicus curiae* submissions). At the same time, the CAI stipulates that the expert panel is not obliged to address any of the arguments made in such submissions. A specific working group will monitor the implementation of this chapter.

1.4. DISPUTE SETTLEMENT AND INSTITUTIONAL PROVISIONS

For disputes concerning the interpretation and application of the CAI's provisions, the agreement establishes a standard state-to-state DSM, like those included in all recent EU FTAs. This procedure first provides consultation mechanisms (and the possibility to mediate) to reach a mutually agreed solution. In the absence of a solution, recourse to an arbitration panel procedure is possible (which can lead to the suspension of preferences in case of non-compliance with the panel report). Whereas state-to-state DSMs under EU FTAs were initially hardly used, the European Commission is increasingly relying on these procedures in the context of its more 'assertive' trade policy that focuses on enforcing bi- and multilateral trade rules (e.g. recently under FTAs with Ukraine, the Southern African Customs Union, Algeria).

The EU and China remain free to have recourse to the WTO DSM instead, to challenge a measure covered by the CAI. However, this would prevent the Parties from being able to also rely on the CAI DSM. The WTO dispute settlement process will remain an important avenue for EU–China trade dispute resolution, considering that the latter is using this system increasingly since it joined the WTO, both as complainant and respondent. In fact, it is now one of the most prolific users of the WTO dispute settlement process and has a good track record of complying with 'lost' WTO cases. The EU's ongoing WTO cases with China concern technology transfer measures and raw materials on the offensive side, and anti-dumping and feed-in-tariff measures on the defensive side.[13]

The WTO dispute settlement process will remain an important avenue for EU–China trade dispute resolution, considering that the latter is using this system increasingly since it joined the WTO, both as complainant and respondent.

The CAI also established an institutional framework, including an Investment Committee that will be co-chaired by a European Commissioner and a Chinese Vice-Premier at the highest level. The Committee will meet yearly and is tasked with ensuring the proper functioning of the CAI and adopting any necessary measures, including binding interpretations of the provisions. All decisions shall be taken by consensus and bind the Parties. A working group on investment, which the EU Director-General for Trade and the Chinese Vice-Minister of Commerce will co-chair, shall meet every six months.

2. The broader context of EU–China trade and investment relations

2.1. *QUID* INVESTMENT PROTECTION AND INVESTOR-STATE DISPUTE SETTLEMENT?

Although the CAI is an investment agreement, it does not cover substantive investment protection standards like monetary compensation for (in)direct expropriation and fair and equitable treatment. Nor does it include ISDS mechanisms that are typically included in bilateral investment treaties (BITs). This is remarkable, as the EU initially envisaged an investment protection agreement to replace the 25 different BITs that all the EU member states barring Ireland have with China. These BITs, which will remain in place, are hardly used by EU investors in China, arguably because EU companies fear Chinese retaliation against their investments or (future) activities in China.[14]

However, the CAI includes a commitment by both Parties to pursue the negotiations on investment protection and investment dispute settlement within two years of signing. The common objective is to work towards modernised investment protection standards and a dispute settlement that accounts for the work undertaken by the UN Commission on International Trade Law (UNCITRAL) Working Group III on ISDS reform. The Commission proposes replacing traditional ISDS mechanisms in UNCITRAL with a 'Multilateral Investment Court' (MIC). Moreover, the EU has recently concluded investment protection standards, including its new bilateral Investment Court System (ICS), in its agreements with Canada (Comprehensive Economic and Trade Agreement), Vietnam and Singapore (Investment Protection Agreements).[15]

China's position on ISDS reform and the EU's proposals remains unclear.

China's position on ISDS reform and the EU's proposals remains unclear. It confirmed in a submission to the UNCITRAL process that it is "open to possible proposals for improving the ISDS mechanism."[16] Moreover, several (but not all) of its proposals are similar to the EU's proposal for a MIC. It remains to be seen whether China will commit to negotiating a bilateral ICS with the EU, particularly as it is developing its own system for investment disputes in the context of, for example, its Belt and Road Initiative.

2.2. A STEPPINGSTONE FOR WORLD TRADE ORGANIZATION REFORM?

The CAI must be considered in the broader context of the triangular EU–US–China trade and investment relationship, and the EU's proposals for WTO reform. WTO reform is one of the key priorities of the EU's new trade strategy, as the European Commission intends to pursue it across all its functions – particularly its DSM and 'rulebook'.[17] Concerning the modernisation of the WTO rulebook, several of the Commission's proposals for reform aim to address the EU's concerns about China's trade-distortive practices, especially the proposed rules on state intervention and competitive neutrality like subsidies, SOEs and FTTs.[18]

The CAI includes several provisions and commitments that go beyond WTO agreements and China's WTO accession protocol. A few specific elements of the CAI have the potential to nudge China to engage in the WTO reform process on rules on state intervention, competitive neutrality and other areas. For example, the Commission's most recent WTO reform proposal, annexed to the new EU trade strategy, states the following: "New international SOE rules should focus on the behaviour of SOEs in their commercial activities, in line with the disciplines already agreed in several free trade and investment agreements."[19]

As noted above, the CAI's provisions on SOEs already include commitments that go in this direction (e.g. the requirement to act based on commercial considerations and non-discrimination commitments). Moreover, the CAI's disciplines on FTTs can trigger corresponding rules at the WTO level, particularly as the US–China Phase 1 agreement also includes disciplines on this issue. In addition, the CAI's provisions on domestic regulation and transparency (Section III on Regulatory Framework) can boost the plurilateral WTO initiatives to establish an Investment Facilitation Agreement and Services Domestic Regulation.

The CAI's rules on subsidies are still a far cry from the EU's proposals for WTO reform.

The CAI does not pave the way to more ambitious WTO rules in other crucial areas. For example, the CAI's rules on subsidies are still a far cry from the EU's proposals for WTO reform. The Commission aims to increase the WTO's transparency requirements regarding subsidies and envisages establishing additional categories of prohibited subsidies, as well as categories of subsidies presumed to be injurious. Together with discussions on such 'red' and 'amber' boxes, the Commission is also considering a 'green box' that includes subsidies that support legitimate public goals while having minimal trade-distortive impacts (e.g. environmental and R&D subsidies). The CAI does not contribute to the realisation of these proposals, as it essentially only focuses on transparency requirements and lacks new disciplines on prohibited subsidies.

Moreover, the proposal on industrial subsidies in the EU–US–Japan trilateral talks goes even further. The three parties proposed adding four new types of prohibited subsidies that Article 3(1) of the Agreement on Subsidies and Countervailing Measures covers. These consist of (i) unlimited guarantees; (ii) subsidies for insolvent or ailing enterprises, in the absence of a credible restructuring plan; (iii) subsidies for enterprises unable to obtain long-term financing or investment from independent commercial sources when those enterprises operate in industries plagued by overcapacity; and (iv) certain direct forgiveness of debt. Other harmful subsidies, such as excessively harmful subsidies or subsidies that prop up uncompetitive firms, would also be prohibited in principle.

Furthermore, the trilateral's proposal is much more ambitious than the CAI with regard to the notification of subsidies. The trilateral proposal states that when a subsidising WTO member does not notify but another member *counter*-notifies the measure, the former's subsidy will be treated as prohibited unless the required information is provided within a short deadline. The CAI does not nudge China in this direction but does leave the door open to an update if the WTO were to establish new rules on subsidies.

So far, neither the EU nor the US managed to extract more ambitious disciplines on subsidies from China in their respective bilateral agreements.

Considering the EU's ambition for a renewed EU–US partnership under the Biden administration, the Commission is prioritising transatlantic cooperation on WTO reform.[20] It envisages addressing shared concerns vis-à-vis China in the WTO reform process, such as on China's subsidies and SOEs, jointly with the US. So far, neither the EU nor the US managed to extract more ambitious disciplines on subsidies from China in their respective bilateral agreements. The US–China Phase 1 agreement does not cover strict rules on subsidies nor SOEs (but does include disciplines on FTTs and IPR). Therefore, the Commission aims to intensify its engagement with the US, to launch negotiations on the development of rules on competitive neutrality, including modernised rules on industrial subsidies, in the run-up to the 12th WTO Ministerial Conference (MC12). The Commission can build further on the work on industrial subsidies established in the trilateral format with Japan, broadening its scope and membership with like-minded countries.

On the other hand, the EU could find a partner in China for its proposals to modernise the WTO Dispute Settlement Body (DSB) and its stalled Appellate Body (AB). The Commission recognises several of the US' concerns on the DSB and AB (e.g. the duration of the procedure and certain adjudicative approaches of the AB), addressing them in its WTO reform proposals.[21] Whereas the Biden administration is yet to take a stance on this issue, China has already aligned itself with the EU's proposals and is, contrary to the US, a member of the WTO multi-party interim appeal arrangement.

2.3. THE EU'S AUTONOMOUS TRADE INSTRUMENTS

The CAI is the EU's bilateral instrument with China to rebalance market access and create a better LPF. However, in parallel with this bilateral approach, the EU is also strengthening its autonomous trade toolbox to deal with unfair trade practices, especially those caused by China. Under the umbrella of 'Open Strategic Autonomy', the EU's new trade policy aims to tackle unfair trade practices more assertively and will focus more on the implementation and enforcement of trade rules – ensuring a fair LPF.[22] The Commission's new Chief Trade Enforcement Officer will be responsible for rolling out and implementing these tools. In this context, the EU has recently adopted or proposes several autonomous trade instruments that target China's distortive trade and investment practices (indirectly) and would complement the CAI. These instruments are outlined below.

The EU is also strengthening its autonomous trade toolbox to deal with unfair trade practices, especially those caused by China.

2.3.1. Foreign investment screening

In October 2020, the EU's foreign investment screening framework became fully operational (Regulation (EU) 2019/452). This instrument came against the backdrop of growing concerns on Chinese investment in key sectors related to cutting-edge technologies. This framework sets up a mechanism between the European Commission and EU member states to cooperate and exchange information on investments from non-EU countries that may affect security or public order. Around 15 EU member states currently have an investment screening in place, and most are developing or updating such mechanisms.[23]

China adopted, partially as a reaction to the EU's foreign investment screening framework, its own new investment screening mechanism in January 2021.

China adopted, partially as a reaction to the EU's framework, its own new investment screening mechanism in January 2021. Although both Parties' instruments are difficult to reconcile with the CAI's objectives (i.e. investment facilitation), they are nevertheless allowed under its national security exception.

2.3.2. International Procurement Instrument

The CAI does not cover PP. The EU has opened its PP markets to third countries to a large degree, including through the revised WTO Agreement on Government Procurement (GPA). However, China has still not committed to opening up its PP market – it is not a member of the GPA –, and EU companies are still largely excluded from China's PP markets.

In view of this, the Commission aims to relaunch interinstitutional negotiations on an International Procurement Instrument (IPI). Amended in 2016, the IPI proposal would enable the Commission to investigate allegations of discrimination against EU parties in foreign PP markets. In addition, it would allow the Commission to consult with the third country concerned to obtain reciprocal concessions on the latter's PP market. As a last resort, the proposal foresees the imposition of a price penalty on tenders originating in the third country concerned. Member states remain deeply divided over this issue, and the Council is still blocking the IPI – Germany is a key opponent.

Both the Commission's 2019 Strategic Outlook on China and 2021 trade strategy calls on the Council to finalise the IPI. Although this instrument was originally intended to break open PP markets in China and other Asian countries, the Biden administration's strong emphasis on 'Buy American' seems to be the catalyst to break the deadlock in the EU. Member states and MEPs are increasingly concerned that EU companies will be excluded (further) from American PP contracts due to these Buy American recovery policies. In this context, trilogue negotiations on the IPI were relaunched in April 2021, and the Portuguese Presidency is expected to present a compromise text before July.

2.3.3. Foreign subsidies instrument

The CAI's provisions on subsidies deal primarily with transparency and establish a consultation mechanism (see section 1.2.2.). In order to deal with the trade-distortive effects in the Single Market caused by subsidies granted by Chinese and other third countries to companies in the EU, the Commission adopted its proposal for a foreign subsidies instrument in May 2021, alongside its new industrial strategy. This instrument aims to close the regulatory gap in the Single Market, as EU competition rules do not cover foreign subsidies that provide an unfair advantage when acquiring EU companies, participating in EU PP, or engaging in other commercial activities in the EU.

The proposed regulation establishes notification-based tools to allow the Commission to investigate concentrations (i.e. acquisitions) and bids in PP that involve non-EU financial contributions above certain thresholds. In addition, a general market investigation tool will enable the Commission to investigate other types of market situations, such as greenfield investments or concentrations and procurements, when it suspects that a foreign subsidy may be involved. If the Commission establishes that a foreign subsidy exists, is distortive and has negative effects, it can impose far-reaching redressive measures or commitments. These essentially combine the Commission's enforcement competences and investigatory powers under the Merger Regulation 139/2004 and EU state aid rules. For example, the Commission would be able to impose a range of structural or behavioural remedies, such as divesting certain assets, reducing capacity or market presence, or prohibiting a certain market behaviour. It would also have the power to prohibit the subsidised acquisition or PP contract from being awarded to the subsidised bidder. Like under EU competition law, the Commission would have the right to conduct on-site inspection visits and impose fines on non-cooperative undertakings. The European Parliament and Council will discuss the proposal under the ordinary legislative procedure.

2.3.4. Other trade defence and enforcement tools

The EU is developing other new tools to deal with unfair trade practices by China and other third countries. The EU has updated its **enforcement regulation** to strengthen its capacity to act in situations in which dispute settlement under WTO or bilateral agreements is blocked (Regulation 2021/167). Moreover, later this year, the Commission will propose a new trade instrument to protect the EU from third countries' coercive actions. The envisaged **anti-coercion instrument** would empower the Commission, in specific situations of coercion, to take trade, investment or other restrictive measures towards the non-EU country exerting the pressure.

Finally, the Commission will keep relying on its traditional trade defence instruments. Case in point, China was already the main target of the amended anti-dumping and -subsidy rules in 2017 and 2018. Most of the EU's **anti-dumping and -subsidy measures** concern imports from China, which, after the US, is the secondbiggest user of trade defence instruments that target the EU (around 20 measures).[24]

2.4. SUSTAINABLE DEVELOPMENT

European civil society and MEPs strongly criticise the CAI's provisions on sustainable development, particularly in relation to forced labour and human rights more generally. Over the past year, China has faced mounting condemnation – including from the EU and the US – over the internment of Uyghurs and other ethnic minority groups in forced labour camps, mainly in the far-western region of Xinjiang.

The scope of the ISD chapter has been criticised as being too limited and its enforcement mechanisms too weak. As noted above, disputes under this chapter are exempted from the general DSM and rely instead on a weaker mechanism that involves consultation and an expert panel. Regarding forced labour, the CAI obliges China to "make continued and sustained efforts on its own initiative to pursue ratification of the fundamental ILO Conventions No 29 and 105".[25] Several MEPs have already stated that China's ratification and implementation of these Conventions should be a precondition for the Parliament's ratification of the CAI. A recent TSD panel report under the EU–South Korea FTA clarified that the steps towards the ratification of fundamental ILO Conventions require ongoing and substantial efforts and that these commitments are legally binding and should be respected regardless of their effect on trade.[26]

The European Commission stresses that the CAI is not the only instrument in the EU's trade and sustainable development toolbox to deal with sustainable development and human rights concerns in China.

In its new trade strategy, the Commission promised a comprehensive review of its 15-point plan on implementing and enforcing TSD chapters effectively by mid-2021. However, the Commission stated that this review would only feed into ongoing and future FTA negotiations, implying that this exercise would not change the text of the CAI. It stresses that the CAI is not the only instrument in the EU's TSD toolbox to deal with sustainable development and human rights concerns in China. The agreement will be flanked by other autonomous tools to address these concerns, including the Global Human Rights Sanctions Regime (see section 2.5.) and the new Single Entry Point that would allow all EU-based stakeholders to lodge TSD-related complaints. Moreover, the Commission will submit a proposal on mandatory due diligence, including effective action and enforcement mechanisms, to ensure that forced labour does not find a place in the value chains of EU companies.

2.5. SIGNATURE AND RATIFICATION

The European Commission and China are working towards finalising the text of the CAI (i.e. legal scrubbing). It will need to be legally reviewed and translated before it can be submitted for approval to the Council and the European Parliament.

The Commission must still determine whether it will propose the CAI as an 'EU-only agreement' or 'mixed agreement'. In the latter case, all 27 EU member states would also need to sign and ratify the agreement, leading to a long and unpredictable ratification procedure. Considering that the CAI does not cover provisions on ISDS – which does not fall under the EU's exclusive competences, as recently ruled by the Court of Justice in Opinion 2/15 –, it is likely that the Commission will propose it as an EU-only agreement. Therefore, it is also unlikely that the Commission will propose to apply the agreement provisionally after the signature and before the ratification by the Council and European Parliament.

The Commission must still determine whether it will propose the CAI as an 'EU-only agreement' or 'mixed agreement'.

The Commission initially envisaged submitting the CAI to the Council and European Parliament for signature and ratification in the second half of 2021. However, in March 2021, China adopted several sanctions against EU officials and entities in reaction to the EU's Global Human Rights Sanctions Regime, condemning several Chinese persons and entities for human rights abuses, including those committed against China's Uyghur minority.

Several MEPs have already stated that the Parliament will not even put the ratification of the CAI on its agenda as long as these sanctions apply against the MEPs. Being that these Chinese sanctions against EU officials and entities are in place, it is also unlikely that the Commission will propose the agreement. Moreover, as noted, several MEPs have already stated that they aim to condition the European Parliament's ratification of the CAI to China's implementation and ratification of the two fundamental ILO Conventions on forced labour. In addition, several MEPs have already voiced that they would prefer first to have the different new autonomous trade tools (e.g. Foreign Subsidy Instrument, IPI, anti-coercion instrument) and TSD instruments (e.g. due diligence scheme) in place to deal with China's unfair trade practices before ratifying the CAI.

These positions were confirmed on 20 May 2021 when the Parliament adopted a resolution with an overwhelming majority that "[c]ondemns in the strongest possible terms the baseless and arbitrary sanctions imposed by the Chinese authorities". The Parliament has put the CAI on ice, as it takes the position "that any consideration of the [CAI], as well as any discussion on ratification by the European Parliament, has justifiably been frozen because of the Chinese sanctions in place" and demands that "China lift the sanctions before Parliament can deal with the CAI, without prejudice to the final outcome of the CAI ratification process". The Parliament also highlights the urgent need to rebalance EU–China relations by adopting the EU's autonomous trade tools.[27]

In response to the rapidly deteriorating political climate, EU Trade Commissioner Valdis Dombrovskis stated on 4 May that the EU "for the moment suspended some efforts to raise political awareness on the part of the Commission". It is "clear that in the current situation, with the EU sanctions in place against China and Chinese counter-sanctions in place, including against members of the European Parliament (that) the environment is not conducive for ratification of the agreement".[28] Whereas technical aspects like legal scrubbing are still ongoing, the Commission will clearly not propose the CAI for signature and ratification unless the political climate improves and China's sanctions against MEPs are lifted.

Conclusion and recommendations

The CAI is not a revolutionary agreement that will break open the Chinese market for EU investors. China's market access commitments in the CAI mainly reflect its recent or planned unilateral foreign investment liberalisation and only provide modest new market openings.

However, this does not mean that the CAI has *no* added value, as it enshrines China's unilateral liberalisation of foreign investment in an international treaty – preventing backsliding and providing for enforcement procedures (although provisions on investment protection are still lacking). Moreover, the CAI includes new rules on transparency for subsidies, SOEs, FTTs, domestic regulation and transparency, all of which relate to the EU's key concerns about China's distortive trade and investment practices. Several of these provisions are still insufficient or not strongly enforceable (e.g. provisions on subsidies and SOEs). Nevertheless, some (but not all) CAI disciplines can serve as a modest starting point for more ambitious rules at the bi- or multilateral (WTO) level.

Whether the CAI would make a significant difference for EU investors would mainly depend on China's implementation of the agreement within the context of its domestic and external economic and investment policies. Although China's last FIL liberalised foreign investment further in several sectors, its recent adoption of a series of investment(-related) laws and policies targeting or restricting foreign investment does not bode well. For example, in less than two years, China has updated its law on (security) screening of foreign investment, adopted a new export control law and a statute to block the extraterritorial effect of foreign legislation and measures, drawn up a list of 'unreliable entities' to punish foreign enterprises deemed harmful to China's sovereignty and security, and enacted a series of security-related laws (e.g. the Cybersecurity Law) which restrict or complicate the Chinese business climate for EU companies.

These tools align with China's state-sponsored industrial strategy, Made in China 2025, which aims to reduce the country's reliance on foreign technology in several strategic high-tech sectors; and its new 'dual circulation' economic model. With the latter, China aims to cut its dependence on overseas markets and technology, mainly due to its trade conflict with the US under the Trump administration. China is seeking to abandon its export-oriented economic model and move towards a more inward-looking and self-reliant development strategy by building up its high-tech capacity through state intervention and inward investment.[29] This may explain why China agreed to a deal that offers little new access for Chinese investors to the EU but facilitates EU investment in China in several strategic sectors (e.g. electronic vehicles).

China aims to cut its dependence on overseas markets and technology, mainly due to its trade conflict with the US under the Trump administration.

Regardless of whether the CAI will eventually be signed and ratified (although it currently looks unlikely), the EU must continue to roll out and implement its autonomous trade tools that address China's trade-distortive practices (e.g. Foreign Subsidies Instrument, IPI). It should use its (new) trade defence and enforcement tools when necessary (e.g. the new enforcement regulation, anti-coercion mechanism, traditional trade defence instruments). The Commission should not back away from applying these instruments in a targeted, proportionate and WTO-compatible way, even if it leads to more counteractions from China (e.g. new investment restrictions, suspension of the CAI). If China takes its envisaged dual circulation model seriously, the Commission will arguably need to focus more on protecting EU investors in China from unfair competition or practices than on dealing with unfair Chinese investments in the EU Single Market.

If China takes its envisaged dual circulation model seriously, the European Commission will arguably need to focus more on protecting EU investors in China from unfair competition or practices than on dealing with unfair Chinese investments in the EU Single Market.

In parallel, the EU must prioritise transatlantic cooperation on WTO reform, proposing new rules that address the concerns vis-à-vis China (e.g. subsidies, FTTs, SOEs) it shares with the US and other like-minded countries. The EU and the US can build on the progress made in the trilateral format with Japan and should set these WTO reforms in motion at the MC12 later this year. However, it will be important to also engage China – the subject of concern – in these talks as soon as possible to avoid Beijing condemning the WTO reform process as an 'anti-China exercise'. A new patchwork of WTO plurilateral agreements on competitive neutrality without China's participation will do little for the sustainability of the multilateral trading system.

Considering the current political and diplomatic tensions between the EU and China, triggered by the recent (counter)sanctions, it is unlikely that the European Commission will propose the CAI to the Council and Parliament any time soon. As long as China's countersanctions against EU officials and entities are in place, the agreement should not be signed and ratified. However, if these diplomatic tensions cool down, the EU must fully leverage the CAI (and its trade and investment powers more generally) to address the human rights and forced labour issues in China. This could be done by requesting additional commitments on, for example, the ratification of the fundamental ILO Conventions in an additional protocol or roadmap, or the development of clear pre-signature and/or ratification commitments.[30] As it is unlikely that China will engage constructively on these issues, the EU should deploy its new or envisaged autonomous TSD tools, such as on due diligence and forced labour, in parallel.

Admittedly, the EU would be sending a mixed message to Beijing with this approach, by committing to open investment relations while also putting into place policy instruments that curb and regulate unfair Chinese trade and investment practices. Nevertheless, it would be completely in line with its new credo of open strategic autonomy.

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