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NOTE

From:	Presidency
To:	The High Level Working Group on Competitiveness and Growth
Subject:	The external dimension of industrial policy

Delegations will find in Annex a Presidency discussion paper on the external dimension of industrial policy, in view of the meeting of the High Level Working Group on Competitiveness and Growth on 9 November 2017.

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ANNEX

The external dimension of industrial policy

The EU's renewed industrial policy strategy reminds us of the importance of the international dimension: while open and rules-based trade is an essential part of our efforts to harness globalisation (every additional €1 billion in exports supports 14,000 extra jobs in Europe), it needs to be fair and sustainable. Restricting trade would only disrupt the complex cross-border supply chains on which EU's businesses rely to build global competitiveness. Meanwhile, Europe's competitors are working on upgrading their industry through selective investment policy and direct or indirect state support in selected sectors. Thus, EU's innovation gap with some countries is increasing and the major economic players like China are starting to compete in those higher added value segments where Europe has been so far holding the leader's position.

Therefore, to supplement the proactive trade agenda of the EU in line with the Commission Trade for All Communication and the ongoing legislative work on strengthening trade defence instruments, the Commission has proposed a new framework to screen foreign direct investments aiming at ensuring that Member States may effectively defend their security and public order. These measures address the increasing challenges of global unfair competition, such as dumping and subsidisation, strategic (government supported) investments aiming at technology and know-how transfer to or through foreign state-owned enterprises.

In order to facilitate the discussion, we will give below an overview of EU's inbound and outbound investment flows, the recent proposal by Commission on foreign direct investment screening and the Chinese industrial policy followed by questions for discussion.

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The investment flows into and out of EU with a particular focus on China

The European Union has one of the world's most open investment regimes, and based on the OECD FDI Regulatory Restrictiveness index[1] the EU Member States have collectively the fewest restrictions in the world for foreign direct investment. The EU is also the world's leading source and destination of FDI. At the end of 2015, the stock of inward FDI in the EU stood at over €5.7 trillion while it reached €5.1 trillion in the USA and €1.5 trillion in China, including Hong Kong. EU investors held €6.9 trillion in FDI in third countries in the same year with inflows of €467 billion and outflows of €537 billion in 2015[2]

Non-EU investors control only 0.4% of EU companies, but being bigger than average, they represent about 13% of total turnover, 11% of value added and 6% of total employment in the EU. The USA is at the top of the list with 26,000 controlled companies in the EU. China controlled around 4 000 companies in the EU. In 2016, there were 1869 announced FDI transactions involving an extra-EU acquisition of a stake above 10% in an EU enterprise[3].

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 (85% of this annual increase came from three large transactions (Supercell, KUKA and Global Switch). 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.

1 The OECD FDI restrictiveness index 2010 update is calculated as a simple average of 22 sectors covered (agriculture, forestry, fishing and mining, 5 subsectors of manufacturing, 11 services sectors and real estate and electricity), with different weights assigned to different sectors. Intra-regional liberalisation is taken into account for economic integration such as within EU. http://www.oecd.org/investment/fdiindex.htm

2 Source: Eurostat

3 Sources for this section: MERICS study "Made in China 2025" (December 2016), EUCCC Study "China Manufacturing 2025" (March 2017) and Rhodium report "Made in China 2025" (November 2016).

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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. Also, the Chinese investment stock in EU in 2015 was €34.9 billion and the EU investment stock in China was €168.4 billion. Hence, Chinese FDI still accounts for a small share of total FDI inflows into and stock in 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.

As regards the FDI by state owned enterprises, the EU remains the world's leading home country for state owned multinational enterprises (420), followed by China (267) and Malaysia (72)[4].

It is interesting to note that the EUCCC's business confidence survey (May 2017) showed that 56% of EU companies would invest more in China if better market access was granted. Only 15% of respondents believe that regulatory barriers in China will decrease over the next five years, while 40% believe that they will actually increase.

To solve this problem, the EU is engaged in negotiating a Comprehensive Agreement on Investment (CAI) with China that covers both market access and investment protection provisions, aiming at addressing, inter alia, the problem of performance requirements in general and forced technology transfers in particular. The negotiations started in 2013 but progress on market access has been so far slow.

[4] UNCTAD World Investment Report 2017, http://unctad.org/en/PublicationsLibrary/wir2017_en.pdf

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The Commission proposal for investment screening framework *COM(2017) 487 final*

The Commission's reflection paper of 10 May 2017 on Harnessing Globalisation[5] recognised increasing concerns about strategic acquisitions of European companies with key technologies by foreign companies owned or controlled by third countries' governments. In June 2017, the European Council welcomed the Commission initiative to analyse investments from third countries in strategic sectors[6], while the European Parliament specifically requested "to screen third country foreign direct investments in the EU in strategic industries, infrastructure and key future technologies, or other assets that are important in the interests of security and protection of access to them".

On 13 September 2017, the Commission proposed a Regulation[7] establishing a framework for screening of FDI in the EU on the grounds of security and public order without an accompanying impact assessment. The proposal would allow those Member States who so wish to screen the investments in strategic sectors without harmonising the screening instruments. It also allows any other Member State and the Commission to raise their concerns about planned or completed investment in a Member State and obliges the host Member State to provide detailed information about the concerned investment to the requesting Member State and the Commission. If the Commission issues an opinion, the host Member State, whether having or not having an investment screening system in place, shall take utmost account[8] of this opinion. Furthermore, the Commission may directly screen investments that have an impact on projects or programs of Union interest. This proposed framework aims to ensure enhanced cooperation among Member States and with the Commission on FDI that may threaten security and public order in the EU as well as increased transparency on FDI coming into the EU through introduction of annual reporting obligation on top of the cooperation framework.

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[5] https://ec.europa.eu/commission/publications/reflection-paper-harnessing-globalisation_en

[6] see para 17: „…it welcomes the Commission's initiative to harness globalisation and, inter alia, to analyse investments from third countries in strategic sectors, while fully respecting Members States' competences".

[7] http://europa.eu/rapid/press-release_IP-17-3183_en.htm

[8] On interpretation for „utmost account, see EUCJ C-28/15

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Furthermore, the Commission proposal is accompanied by a Communication on Welcoming FDI while Protecting Essential Interests[9]. The Communication foresees setting up a coordination group on inward foreign direct investment that will exchange information and best practices, discuss issues of common concern and facilitate analysis on FDI and secondly promises an in-depth analysis of inward investment flows in strategic sectors to EU by end of 2018.

The Chinese Industrial Policy: Made in China 2025 (MiC 2025)[10]

According to 2015 figures, China has become the biggest player in global manufacturing, ahead of the EU and USA[11] though the GDP per capita of China is still clearly below leading economic regions, and with relative high shares of agriculture and industry. Drawing direct inspiration from Germany's "Industry 4.0" plan, the Chinese long-term industrial policy MIC 2025 aims to turn China into a "manufacturing superpower" and outlines its technological development path until 2049, with 2025 representing an intermediary step. The funding of the initiative is impressive: (i) Advanced Manufacturing Fund (€2.7 billion); ii) National Integrated Circuit Fund (€19.1 billion); iii) Emerging Industries Investment Fund (€5.5 billion).

The strategy targets ten strategic technologies[12] and sets market share targets for both local and global market. The domestic targets aim at substituting imports and boosting the domestic industry through subsidies and practices targeting foreign industry (e.g. technology transfers, specific domestic content requirements, etc.). Global targets could potentially lead to overcapacities and distort competition in the global market. Furthermore, the strategy directs and supports Chinese companies (notably State Owned Enterprises) to acquire – by way of increasing FDI - strategic technology abroad. China claims that MiC 2025 is available also to foreign companies, but there is little evidence to support it.

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9 COM(2017)494 final, https://ec.europa.eu/transparency/regdoc/rep/1/2017/EN/COM-2017-494-F1-EN-MAIN-PART-1.PDF

10 Sources for this section: MERICS study "Made in China 2025" (December 2016), EUCCC Study "China Manufacturing 2025" (March 2017) and Rhodium report "Made in China 2025" (November 2016) as well as https://www.csis.org/analysis/made-china-2025

11 http://bruegel.org/2017/09/remaking-europe/

12 New generation information technology; High-end computerised machines and robots; Space and aviation; Maritime equipment and high-tech ships; Advanced railway transportation equipment; New energy and energy-saving vehicles; Energy equipment; Agricultural machines; New materials; Biopharma and high-tech medical devices.

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This strategy can create opportunities for EU companies in the short term, as China needs technology, know-how, and "leading" talent in targeted sectors to respond to the huge political push. This is notably the case for EU companies that provide advanced capital equipment, as well as key components and technologies that China is not yet able to produce itself. However, in the medium and long term, MIC 2025 poses a fundamental challenge to EU companies on global markets as the relative competitive position of Chinese industry will be upgraded making them more competitive both domestically as well as globally.

With the launch of MiC 2025, different Chinese cities and provinces have redoubled efforts to attract foreign companies and technology transfer. The foreign companies operating in China are often required to surrender technology in return for the right to invest and sell in China. The mechanisms may be joint ventures with Chinese firms, licensing agreements, participation in China based R&D Centres etc. These developments reinforce the need to protect EU companies' IP rights and to ensure that EU companies, particularly SMEs, are well informed and able to protect their technology adequately.

A similar strategy has been already seen in the solar power and railway sectors a decade ago. The way in which it is currently playing out might be more visible in new energy vehicles (NEVs) sector where MIC 2025 envisages a domestic market share higher than 70 percent by 2020, and higher than 80 percent by 2025. This is supported also by regulations like the recently adopted NEV Credit Quota, which establishes that manufacturers and importers obligation to fulfil a minimum percentage of NEVs in their car fleet (10% in 2019 and 12% in 2020). While all major Western carmakers announced joint ventures in NEV sectors with Chinese partners, it remains debatable if this can endanger the future of EU’s automotive sector. Two considerations need to be pointed out: (i) the risk of technology transfer seems to be outweighed by size and potential of the access to the Chinese market and (ii) Joint ventures did not help China to capture the combustion engine market in the past. In fact, China is currently considering allowing foreign carmakers to set up wholly owned electric-vehicle businesses in the free trade zones.

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Meanwhile, the Commission is closely monitoring the implementation of MiC 2025, particularly its compliance with WTO rules and other international standards.

Question 1: In your view, how might the proposed investment screening framework impact the competition in the EU and the competitiveness of EU companies? Moreover, would the administrative burden and compliance costs balance the long-term strategic gains for EU?

Question 2: How should we react to MiC 2025 knowing its short-term opportunities but also the dangers for the longer term?

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