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Hearing on China's Expanding Influence in Europe and Eurasia

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Introduction

Chairman Keating, Ranking Member Kinzinger, Distinguished Members of this Committee, thank you for inviting me to testify before you for the second time.

This hearing takes place in a context of a shift in the attitudes of both the United States and Europe towards China's growing economic and geopolitical rise, as well as a broader evolution of Beijing's own priorities and external strategy.

For the past seven years, I have been focusing on China's geo-economic outreach with a focus on foreign direct investments, and how these are perceived in Eurasia, including Europe, the Caucasus and Central Asia. Eurasia is a complex concept with diverging definitions and has been a playing field for competition or cooperation between big powers especially Russia, China, the United States and the European Union (EU).

Although I have also been working on Central Asia, I have decided today to focus my testimony on recent developments between China and the European continent.

While the U.S. has taken a tougher stance in dealing with China's persistent lack of reciprocity in economic relations and violations of international norms of intellectual property for some years, European countries have recently begun reacting concretely to the economic and security-related considerations linked to certain Chinese investments on their soil. The EU's official acknowledgment of China as a "systemic rival" in a policy document released this spring marks a departure from previously conciliatory language.[1]

At the same time, Chinese investments on both sides of the Atlantic have declined considerably after peaking in 2016. Beijing is increasingly curbing private outward investment to maintain its stock of foreign reserves and to direct capital to domestic use amid a period of economic slowdown. The notable exceptions are foreign direct investments (FDI) connected with President Xi Jinping's flagship strategy to achieve technological parity in key industries, *Made in China 2025*, and investment towards the *Belt and Road Initiative* (BRI), Xi's other grand plan to connect China to its markets through large-scale infrastructure projects. The BRI now counts new European signatories, including Italy, one of the EU's founding members, which also became the first G7 nation to sign a Memorandum of Understanding with China in March 2019.

The latter episode has provided an important test for the U.S.-Europe security relationship. Upon the urging of American diplomats not to take part in the BRI, Italy has loudly reiterated its allegiance to NATO and the underlying Western alliance. Yet is has chosen to defy both the U.S. and EU strategic posture in its decision to adhere to the project.

The greatest challenge is that Chinese investments in strategic sectors can generate economic dependence, especially among smaller countries and struggling economies, and this relationship can expand into the political realm, as it has on a few occasions that I will mention shortly.

Against this backdrop, the U.S. and Europe need to consider how they can maintain their security relationship to meet mutual challenges, but also how to reconcile diverging strategies for handling the emergence of China in order to avoid an escalation of tensions and to build instead a constructive relationship with Beijing.

[1] "Communication-EU-China-a-Strategic-Outlook.Pdf," March 12, 2019, https://ec.europa.eu/commission/sites/beta-political/files/communication-eu-china-a-strategic-outlook.pdf.

Over the brief time of this testimony, I will address the following questions and concerns:

- What is the state of Chinese Foreign Direct Investments in Europe
- Following multiple visits and summits in Europe and the BRI Forum in Beijing, what is China's vision towards Europe?
- How is the European Union—and how are individual countries—reacting?
- Is China's growing economic presence translating into political influence in Europe?
- How is the EU responding to the BRI?

Overview of Chinese FDI in Europe

Economic relations between Europe and China have expanded dramatically over the last decade. The EU is now China's largest trading partner, and China is the EU's second-largest trading partner after the United States. China's annual FDI into the EU skyrocketed from $840 million in 2008 to $42 billion in 2017, covering a wide range of geographic areas and industrial sectors. The count about doubles when including Switzerland, a non-EU country, which has captured the lion's share of Chinese FDI with ChemChina's acquisition of the agri-business giant Syngenta for $43 billion—the world's single largest acquisition by a Chinese company.

However, data from the last two years indicates that in aggregate terms Chinese FDI into Europe is slowing down from its 2016 peak. In 2018, Chinese FDI in Europe declined by 40% compared to 2017, for a total of $22.5 billion.[2] Part of this downward trend relates to fewer "mega-deals" being pursued or completed, whereas multi-billion deals were a key feature of total FDI in previous years. Similarly, 2018 saw a shift away from infrastructures, utilities, and real estate projects in favour of more consumer-facing sectors.

The United Kingdom remained the largest European recipient of Chinese FDI for 2018, followed by Sweden, Germany, Luxembourg, and France. Behind the headline of an aggregate fall in FDI, 2018 saw sharper increases in a more diverse pool of European countries: Spain, Sweden, Luxembourg, Denmark, as well as Hungary, Croatia, Poland, and Slovenia all saw growing investments.[3] The overall value of deals was nothing to remark on, especially for smaller and Eastern European countries, but it is significant insofar as it marks a growing Chinese presence in a wider range of countries and significantly in several EU member states. The British case deserves a close attention as the country prepares to exit the union.

The 2017-2018 decline in FDI in Europe is largely the outcome of the Chinese government's recently introduced controls on private capital outflows. Besides the decline in outbound FDI, there has also been a considerable wave of divestments, estimated at $5 billion. It includes large private companies such as HNA or Dalian Wanda that had invested substantially in European countries, but have recently sold some of their assets. However, Europe continues to receive most of its FDI from state-owned enterprises (SOEs), which made up about 63% of total FDI between 2008-18.[4] Unlike private firms

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[2] Hanemann, Huotari, and Kratz, "Chinese FDI in Europe: 2018 Trends and Impact of New Screening Policies".
[3] Chinese FDI into North America and Europe in 2018 Falls 73% to Six-Year Low of $30 Billion | Newsroom | Baker McKenzie."
[4] "EU Reaches Deal on Screening Measures for Foreign Investment," accessed February 24, 2019, http://country.eiu.com.ezp-

(which have made up a majority of FDI in the U.S. for instance), SOEs are less restricted in their ability to invest abroad, especially on projects backed by Beijing and compatible with *Made in China 2025* and the BRI[5]. On top of this supply-side restriction on FDI, European countries have followed somewhat in the U.S.' footsteps and began to scrutinize investment, especially from SOEs, with the effect of reducing the volume of deals.

On the other hand, China ranks 59th out of the 62 countries evaluated by the Organization for Economic Cooperation and Development (OECD) in terms of openness to FDI. Almost half of companies surveyed in 2018 by the European Chamber of Commerce in China said they missed out on business opportunities due to regulatory barriers or market access restrictions, and they expected obstacles to increase during the next five years. It is increasingly evident that many European countries are unhappy with the lack of reciprocity and the joint ventures forced upon European firms to do business in China (which often entail a form of technology transfer). Only smaller countries appear to continue to view one-way FDI as a sufficiently good trade-off. New regulations announced at the recent session of the National People's Congress in Beijing might bring more openings for European companies in the next year, but the real changes will come when the EU and China finally settle on a Comprehensive Agreement on Investment (CAI).

Recent Developments in EU-China Relations

The past three months have seen some of the most significant developments and responses to challenges in Europe-China relations. These include both increased cohesion at the EU-level, especially among the largest EU members, and divergence on key foreign policies such as adherence to the BRI.

With regards to the latter, Italy became the first G7 country to formally endorse the BRI in March. Switzerland followed suit on April 29. They joined 22 other European countries who had already signed MoUs: Austria, Bosnia-Herzegovina, Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Greece, Hungary, Latvia, Lithuania, Luxemburg, Malta, Montenegro, North Macedonia, Poland, Portugal, Romania, Serbia, Slovakia, Slovenia, and Ukraine. In the Chinese original conception of the BRI[6], Europe is the final destination of this ambitious project, and still represents the largest and most attractive consumer market for Chinese products. Having more European countries signing in to the BRI is a major success in the Chinese domestic political context. At the second BRI Forum organized in Beijing in April 2019, no less than 12 European heads of State and heads of governments attended, including those of Austria, Hungary, Italy, Greece, Portugal, the Czech Republic and Malta[7].

The Balkan countries, with the exception of Croatia, are not EU members. For that reason, they are eager for Chinese investments, do not require a visa for Chinese visitors and have little barriers for FDI at all. China is investing massively in this part of Europe. Five of these Balkan states and 11 EU Eastern European member states form the 16+1 group, which gathered for its 8th Summit Meeting in Croatia on April 10-11 attended by Premier Li Keqiang. Greece has now joined this group, which has been re-labelled as 17+1.

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prod1.hul.harvard.edu/article.aspx?articleid=507371234&Country=Italy&topic=Economy&subtopic=Forecast&subsubtopic=Policy+trends.

[5] This includes projects that were not originally part of the BRI when it was created, but have since been labelled as such.

[6] Although it still remains a fairly vague global concept, the BRI now includes every continent in the world with the exception of North America

[7] Notably, leaders of Germany, France and the United Kingdom did not attend the BRI Forum

On the other hand, larger EU member states are broadly wary of entertaining purely bilateral relations with Beijing, and instead favour a coordinated EU approach that can effectively stand up to China as an equal power. For instance, France's President Emmanuel Macron summoned German Chancellor Angela Merkel and European Commission President Jean-Claude Juncker to Paris on occasion of Xi Jinping's state visit in March. Again, Germany's Economy Minister told the press from the Belt and Road Forum that took place in late April that large EU member states had "agreed" not to sign similar deals on a bilateral basis, but as a European bloc.

Thanks to the alignment of its largest members, the EU has recently taken three main steps on the foreign policy stage that signify a change of attitude towards China.

Firstly, in March the European Commission, the EU's executive body, issued a "Strategic Outlook" in which it labels China as a "systemic rival" and "strategic competitor" and sets out a number of intended steps to contrast the lack of reciprocity and violation of international rules. "China is, simultaneously, in different policy areas, a cooperation partner with whom the EU has closely aligned objectives, a negotiating partner with whom the EU needs to find a balance of interests, an economic competitor in pursuit of technological leadership, and a systemic rival promoting alternative models of governance", it says. Such language is unusually bold for the EU and captures the concerns of EU institutions and several member states with an increasingly felt Chinese presence on its soil and periphery.

Secondly, on April 5th, the EU concluded the process to introduce a centralized FDI screening mechanism and instructed the roughly half of its member states that still lack equivalent domestic measures to introduce them too. This investment screening mechanism is a relatively loose, non-binding cooperation and oversight system. It encourages sharing information across member states about the potential for given investments to affect national security and interests, and empowers the Commission to weigh in on deals that affect multiple member states or the EU as a whole. The EU screening mechanism sets out the goal of gradual convergence of individual member states' regimes and calls for monitoring and reporting by member states. Today only 11 of 28 members lack screening measures or concrete plans to introduce them. The rapid passing of this new EU measure in just 18 months is indicative of heightened concerns over the terms of China's economic expansion.

This measure is largely perceived as targeting China specifically because it makes provisions for dominant characteristics of its investment strategy: a focus on technology and infrastructure sectors, state-linked and funded entities and state-led outward projects. Another key feature of the EU's new screening mechanism targets a specific aspect of some Chinese deals, namely that many are executed via third parties in other states to conceal the Chinese source of ownership and funding. The measure explicitly sets out to prevent the bypassing of national screening by investigating deals within the EU linked to Chinese firms. By one estimate, this FDI screening mechanism would have covered 92% of the value of Chinese FDI flowing into Europe in 2018.[8]

Thirdly, the last annual EU-China summit on April 9, 2019, which took place days after the announcement of the FDI screening measure, concluded with a stern position by the EU. Although the joint statement was lacking in substance, the overall tone of EU leaders was one of frustration and scepticism. Juncker remarked on the slowness of progress, which concerned issues such as revisiting WTO rules and improving reciprocity and IP protection. Brussels called for reciprocity with and a balanced approach to China. It asked China to address certain issues such as its state subsidies to SOEs and forced technology transfers. China has agreed to discuss with the EU how to reform the WTO and

[8] "Chinese FDI in Europe: 2018 Trends and Impact of New Screening Policies", 2019, 19.

open up government procurement to foreign suppliers. Last, but not least, the EU and China did agree on concluding a Comprehensive Agreement on Investment by 2020.

The EU and U.S. share similar goals towards China, and these developments signal fertile territory for EU-U.S. cooperation on this front. However, the EU is unlikely to endorse the confrontational strategy pursued by President Trump, especially since its membership remains overall divided on the subject of China. Instead the EU will continue to reiterate its strong interest in a constructive relationship with China and to pursue common ground through dialogue and cooperation.

Chinese FDI and Political Influence in Europe

Behind the encouraging big picture of concrete steps from Brussels to rebalance the EU-China relationship, Beijing has been making political inroads in several European countries, with implications for the U.S., NATO, and cohesion on security issues.

There are examples of the political influence attached to China's economic presence. The EU's attempt to issue a statement of support for freedom of navigation in the aftermath of the 2016 final ruling of the UNCLOS (United Nations Convention on the Law of the Sea) Arbitration Court in The Hague on the Philippines' case against China over the South China Sea was revised downward. This had followed the refusal of three EU member countries—Greece, Hungary, and Croatia—to sign onto this joint declaration. Portugal, being a major recipient of Chinese FDI in many sectors of its economy, was at first reluctant to support the EU's requirement for certain FDI screening procedures and called them "protectionist". Again, in 2017 Greece blocked an EU statement at the UN Human Rights Council (UNHRC) condemning China's human rights violations—the first time the EU failed to speak with one voice at the UNHRC. Hungary similarly refused to sign an EU joint letter denouncing the reported torture of lawyers detained by Chinese authorities.

But in a climate of rising nationalism, Chinese FDI has also become an issue of rivalry between different European states. When rebutting criticisms of their choice to join the BRI, Italian officials claimed that other European peers traded more and received more investment from China, justifying Italy's pursuit of its fair share as a national interest. However, in the same week France secured several times the commercial value in agreements with China than Italy did, without signing on to the BRI. In this respect, competition and disagreement over China has created tensions that further divide EU members at the political level.

Beijing's strategy to sow divisions is an intentional one. It treats EU members differently and creates its own circles of friends with regular contacts. From China's point of view, northern European countries are one community; southern European countries are another; central and eastern European countries are mostly encompassed in this 17+1 group. France and the UK, being permanent members of the UN Security Council along with China, enjoy more status and beneficial relations with Beijing. Germany is recognized by China as the economic powerhouse of the EU with admirable scientific and technological prowess.

China also earns diplomatic points by affording even the smallest states equal status when it comes to state visits. In addition to March's meetings with heads of states in Rome and Paris, President Xi also visited Monaco, a tiny country with a population of 38,000 people. This could be interpreted as a reward for Monaco's granting a Chinese telecommunication company, Huawei, a contract to build its 5G infrastructure. It should be noted that Huawei has launched an impressive public relations and lobbying campaign across Europe, inviting journalists and politicians to its headquarters and underlining repeatedly its separation from the Chinese state and communist party.

Concerns for Security, NATO, and U.S.-EU Cooperation

Political influence is not the only challenge to maintaining cohesion among U.S. and European allies. Chinese FDI, and its economic presence in European markets also comes with strategic concerns over China's pursuit of technological parity (or even superiority), and its established practices of cyber espionage and hacking.

Competition between the U.S. and China to develop advanced technologies such as Artificial Intelligence (AI), robotics, quantum computing, and biotechnology, with strategic and military applications, directly implicates Europe. Although European countries have fallen behind both the U.S. and China in the technology race, investing in Europe's target industries can still help China to close this gap.

European countries have become more responsive to this challenge. The acquisition in 2016 of a premier German robotic company, Kuka by Midea Group, a Chinese home appliance manufacturer, woke up the German establishment to the risk that China could threaten its technological pre-eminence and national security[9]. Subsequently, Germany blocked the acquisition of chip maker Aixtron by Fujian Grand Chip Investment Fund, revoking an approval it had previously granted due to new evidence relating to security and meeting the criteria "security of supply in the event of a crisis, telecommunications and electricity, or the provision of services of strategic importance".[10] CFIUS has come out against the deal and provided the German government with evidence that motivated the withdrawal of its prior approval.[11]

Even without the EU screening system, in 2018 EU members' own FDI screening rules contributed to blocking seven deals for a value of $1.5 billion, mainly on national security grounds.[12] Germany introduced its domestic screening measure in 2017, which was first exercised to block the Chinese acquisition of machine tool company Leifeld Metal Spinning AG, whose nuclear and rocket technology expertise was deemed sufficient grounds to invoke a national security ban.[13] Shortly before the German government had also resorted to investing its own money in 50Hertz Transmission GmbH to avert China's State Grid from acquiring a 20% stake in the electricity grid operator.[14] Even Italy, whose coalition government appeared to be committed to a strong relationship with China during President Xi Jinping's March visit, is responding to internal calls (largely from Deputy Prime Minister Matteo

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[9] The Federation of German Industries (BDI) published an important report on the subject in January 2019 https://english.bdi.eu/article/news/strengthen-the-european-union-to-better-compete-with-china/

[10] Guy Chazan, "Germany Withdraws Approval for Chinese Takeover of Tech Group," Financial Times, October 24, 2016, https://www.ft.com/content/f1b3e52e-99b0-11e6-8f9b-70e3cabccfae.

[11] "Germany's Aixtron Says U.S. Opposes China Deal on Security Grounds," *Reuters*, November 18, 2016, https://www.reuters.com/article/us-aixtron-m-a-fujian-usa-idUSKBN13D2Q8.

[12] "Chinese FDI into North America and Europe in 2018 Falls 73% to Six-Year Low of $30 Billion | Newsroom | Baker McKenzie," accessed April 16, 2019, https://www.bakermckenzie.com/en/newsroom/2019/01/chinese-fdi.

[13] Andrea Thomas, "Germany Vetoes Chinese Purchase of Business Citing Security Grounds," *Wall Street Journal*, July 26, 2018, sec. Business, https://www.wsj.com/articles/germany-vetoes-chinese-purchase-of-leifeld-metal-spinning-1532624172.

[14] "Germany Steps Up Efforts to Rebuff China's Swoop for Assets," July 27, 2018, https://www.bloomberg.com/news/articles/2018-07-27/germany-buys-stake-in-electric-grid-operator-to-block-chinese.

Salvini and his Northern League) to broaden the government's "golden powers" to block deals that threaten national security and economic autonomy.

The U.S. and Europe remain largely divided over Huawei Technologies and the extent of the security risks linked to its inclusion in the development of 5G infrastructure. The U.K. recently approved Huawei as a supplier of 5G services but kept it out of critical parts of the network. Germany has similarly allowed the telecoms giant, and Italy is debating its position internally but seems to be leaning in favour of following its European peers. The U.K. and Germany even set up security evaluation centres to monitor Huawei services on their soil, but British intelligence services claimed that even this monitoring only had limited capacity to guarantee security. In the meantime, recent days have seen revelations that software backdoors were found in Huawei equipment as early as 2009 by carrier Vodafone in Italy, and that despite recurrences to the contrary they remained in place at least until 2011. Although Vodafone said the issue was eventually resolved, this precedent, if further evidence corroborates it, should discourage allowing Huawei to operate at least the most sensitive components of 5G networks in NATO countries.

While Europeans' concern with Huawei is largely limited to the ability of the Chinese government to exploit the company (which ownership system remain unclear[15]) to spy on the countries and conduct cyber-attacks, the U.S. is also significantly worried about the effect of sustaining the growth of a critical industry in a rival country that could cost U.S. and European firms their technological lead. A key motive for the U.S. pressure to ban Huawei that is not well received in Europe is that Western providers should be bolstered to win a "5G race".

Besides the question of Huawei, Europe has to grapple with Chinese ownership or control of physical infrastructure and the security risks that arise from it. Chinese state-owned enterprises (SOE), with backing from state funds often under the BRI label, are expanding their control of key European port assets and increasingly also rail links and utilities. Therefore, the use of European ports for U.S. and NATO naval operations could be compromised, as it may happen in the case of the Israeli port of Haifa, which will be operated by Shanghai International Port Group (SIPG) from 2021.

NATO as an organization is only starting to look at China as a part of its reflexion, but the bigger question is whether the Alliance is the ideal forum for this new strategic orientation. In one respect of military salience, the emergence of a Russia-China nexus directly affects NATO's primary mission. The Sino-Russian relationship should not be exaggerated, but the two countries have been conducting joint naval exercises in the Mediterranean, Black Sea, and Baltic Sea.[16] Their military leaderships have increased their exchanges. On the other hand, intra-European divisions on China may translate into lower effectiveness of NATO, making it a weak platform for pursuing a cohesive strategy to contain China's ability to project power.

To conclude, Europe has started re-evaluating its policies with respect to the China challenge. The necessary measures for ensuring critical technologies and infrastructures are protected are now largely in place, but their implementation and enforcement will make the difference between continued vulnerability and effective security. Europe also remains divided, with a number of countries at its periphery benefiting from Chinese economic assistance. Still, the European Union is now standing as one of the strongest advocates of liberal and democratic values in the world, many of them shared on

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[15] Donald Clarke and Christopher Balding, "Who owns Huawei?", SSRN, April 19, 2019 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3372669

[16] Erik Brattberg, "Time for NATO to Talk About China," Carnegie Europe, accessed May 5, 2019, https://carnegieeurope.eu/strategiceurope/78684.

this side of the Atlantic. The rise of China in an increasingly multipolar world should be part of the transatlantic discussion. Bearing in mind European sensitivities, the U.S. Congress should use all its possibilities to collaborate with Europe to build consensus over the immediate security, technological and geo-economic sides of China's expansion. As the current U.S. Administration continues to send mixed messages to America's European allies, it is critical that Congress take a leading role in reinforcing a transatlantic dialogue on China's global influence.

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