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# Hungary external relations briefing: Chinese direct investment and FDI screening in the European Union

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# Chinese direct investment and FDI screening in the European Union

*Attitudes towards foreign direct investment have changed considerably in the last 5-7 years. While the period from the early 1990s onwards was mainly characterized by growing economic interdependence, a positive attitude towards the economic and social impact of FDI and an explicit willingness to attract more and more FDI, the landscape has become much more complex for now. Geopolitical imperatives now determine attitudes towards investment. Whereas in the past it did not matter where the capital or the investor came from, but the sectors or value added and the investment were important to the recipient country, in today's world foreign direct investment is often viewed with skepticism. This briefing looks at the changed attitude towards FDI, the development of FDI patterns in the EU and Hungary.*

**Introduction**

Against the above historical background, it is understandable why the issue of screening foreign direct investment was off the table during the decades from 1990 to 2010. Only in sensitive areas (military or defense sector) was one protected from the inflow of foreign capital, even in the heyday of globalization. As investment from China, Russia and the Middle East increased from the Great Financial Crisis (2008-2009) onwards, so did the need for investment screening. This change in attitude reflected two things:

1. one was the growing appetite of third countries (China, Russia, rich Middle East countries) to go abroad and their increasing competitiveness;
2. the other thing that required a change in behavior was a marked difference in the models of economic development.

The difference in economic models is striking when we think of the Single Market, and China. While in China extensive state subsidies and planning are part of economic development, the need to maintain the Single Market forced the European Union from the outset to introduce and implement a system that controls and limits the amount of state subsidies that can be granted by member states to domestic companies.

Furthermore, not only is the amount of state subsidies tightly controlled by the European Commission, but the principles of how these transfers can be distributed are also determined by European regulations. In contrast to China, Russia or the United States, horizontal subsidies are favored by the European Commission, i.e. the subsidies are preferably spent on, for example, technological development, promoting employment or the fight against climate change, etc. In contrast, other countries concentrate financial transfers on sectors such as ICT, the automotive industry or other clearly defined sectors.

The European approach reflects a neoliberal economic philosophy and emerged after the first oil crisis, when the Keynesian sectoral development approach was indeed inefficient under the conditions of the time. At the same time, economies with neoliberal solutions seem to be at a disadvantage in our time, where the direct sectoral focus successfully produces national champions that could gain a foothold in global markets. In this environment, the war in Ukraine has made European countries more suspicious of foreign direct investment from third countries and the system of economic sanctions against Russia and China has not alleviated the fears of Western European countries towards investment from third countries. The next chapter looks at recent FDI data and attempts to give a review of China's position as direct investor in the EU.

## Global and European trends in foreign direct investment flows

Foreign FDI amounted to USD 1 294 billion in 2022, compared to USD 1 487 billion in 2021 which means a significant decline. The figures for 2022 indicate that foreign direct investors have become more hesitant in recent years and that it will take a few more years before we exceed the peak in FDI flows - 2025: USD 2 056 billion. (We only have FDI data from the third quarter of 2023, the last quarter is not covered with data yet.) In the third quarter of 2023, global FDI flows increased significantly by 36 percent compared to the previous quarter, mainly due to the increase in the US and Ireland. However, despite this increase, FDI flows in the first nine months of 2023 remained 15 percent below the level of the same period in 2022. In Q3 2023, the US and Ireland were the main recipients of FDI inflows, while the US (USD 110 billion), Japan (USD 60 billion) and China were the main sources of FDI outflows (53 billion USD).[1]

In the next part, we present the results of the European Commission's paper "Screening

1 https://www.oecd.org/investment/statistics.htm

of FDI into the Union and its Member States", which was attached to the Commission's report to the European Parliament and the Council.[2] We stress data related to China's investment position in the EU

1. China's share of acquisitions in 2022 was 2.3 percent, while the US (32.2%), the United Kingdom (25.1%), Switzerland (8.9%), Norway (4.3%), Canada (4.1%) and Japan (3.4%) significantly outperformed China.
2. China's share of greenfield investment was slightly larger in 2022 (3.9%), but even in this case the country lagged behind the EU's traditional investors in 2022, as their share were significantly larger than China's. (US: 46.5%, UK: 19%, Switzerland: 4.8%).
3. The accusation that China is strategically targeting high-tech companies with its takeovers cannot be substantiated on the basis of the data. From 2021 to 2021, the proportion of Chinese takeovers in the low-tech sector fell from 80.00 percent to 58.33 percent.
4. At the same time, China brought high-tech to the EU in the form of greenfield investments. In 2021, the share of high-tech greenfield investments in the manufacturing sector was 90.00 percent. In 2023, the share was 93.9 percent.
5. In 2022, the value of greenfield investments fell in all target countries except one. In Ireland, greenfield investment increased by 60 percent, while other key target countries for greenfield investment attracted significantly less greenfield investment from China. The total value of greenfield investments fell by 46.3 percent from 2021 to 2022.
6. A look at the sectoral distribution of greenfield investments shows that retail (-52.3%), manufacturing (15.3%) and finance (-45.5%) suffered in 2022. At the same time, greenfield investments in ICT (500%) and scientific and professional services (225%) have improved significantly.[3]
7. Looking at the strategically important semiconductor sector, the US was the main investor in this area with a share of 47.1 percent in 2022, while the UK (14.7%) and Japan (7.4%) also invested more in this sector than China, whose investments accounted for 5.9 percent.

If we look at the trends, we can see that China is far from being the most important

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2 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52023SC0329
3 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52023SC0329

investor in the EU, regardless of the form of investment (acquisitions and greenfield investment). In the cases where Chinese companies enter the market, it is for high-tech products.

**Policy aspects in the light of decoupling**

The above detailed changed attitude toward FDI is part of the so-called decoupling process. While we can argue that the United States has taken significant steps to decouple from China, the European Union is in a different situation for three reasons.

1. For most EU members, we can see the political will to reshape supply chains and reduce the (perceived) geopolitical risks of trade with China, but we cannot see how this will be done. In terms of EU FDI in China, Germany and France seem to play a central role, while other EU members play a rather insignificant role in this regard. German direct investments in China follows the "in China for China" model, which means that German factories in China target the Chinese market, while American companies mostly follow the "in China for the world" model. The withdrawal of German companies would lead to the total loss of the target market, while American companies only risk the Chinese market through redistribution.
2. When it comes to trade decoupling, the EU is in a worse position than the US, as the US can rely on its domestic technology and resources, while the US seeks to regain access to certain stages of the production chain. This cannot be repeated for EU members, as they rely on a range of sectors, from rare earths to renewable energy equipment or medical ingredients. For this reason, European bureaucrats and politicians are more cautious and like to use the term de-risking instead of de-coupling.
3. Differences between the American and European processes include: in the United States, security and geopolitical arguments dominate among proponents of re-shoring, while in the EU, aspects of the fight against climate change feature strongly alongside those already mentioned. In contrast to the EU countries, the United States has most of the essential raw materials needed for the green revolution and to strengthen domestic production.

The situation is complex because when we analyze macro trade data, we do not have the sense that global supply chains are in flux. The EU and the US have posted record trade deficits with China so far this year, and this data does not explain what is happening at the

bottom. A study by the Bank for International Settlements[4] shows that global companies' reliance on cross-border suppliers will decline significantly between 2021 and 2023, especially for Western companies that ship directly from China. However, this does not mean that trade networks involving only Western countries will be recreated, but that consumers will continue to source products from China via integrated countries such as Vietnam. The result is a significant increase in indirect country linkages as new companies are integrated into existing supply chains. One consequence of this is that Western companies will remain exposed to geopolitical changes, because if China does not sell to incumbents, end consumers in the West will continue to suffer. Secondly, the lengthening of supply chains will make it more difficult to monitor the activities of supplier companies. Thirdly, the real reason for creating single-tier trade (direct from China) is to reduce costs. A multi-tier system will increase costs and therefore we can predict a period characterized by slow growth and higher inflation.[5]

There are several studies on the costs of decoupling from China, including the study by Febermayr[6], which states that decoupling from China would lead to an income loss of 1 percent in the EU. Furthermore, we can point out that shifting production to Europe would not only reduce incomes but also increase the likelihood of regional supply shocks.[7] The question is whether the logic of economics is being overridden by politics. The last few months suggest that the decoupling from China will happen soon, the only question is when this will be the case.

Based on the above, the issue of rare earths and the import of electric cars from China must be highlighted since they stand at the center of geopolitical contest in the world. Let us see the facts:

1. Of the 30 raw materials that the EU classifies as critical, 44 percent come from China.
2. According to the latest data, 98 percent of rare earths are exported from China.
3. As a result of the Belt and Road Initiative, more and more Chinese state-owned enterprises are investing in the global mining business.

4 https://www.bis.org/publ/bisbull78.pdf
5 https://www.ft.com/content/98766d3f-65ad-41c0-84cc-9b6e2757a17c
6 https://www.econstor.eu/bitstream/10419/242494/1/KPB-153.pdf
7 https://www.intereconomics.eu/contents/year/2022/number/6/article/reshoring-by-decree-the-effects-of-decoupling-europe-from-global-value-chains.html

4. In addition, Beijing has signed strategic agreements with several countries to gain access to the supplies that these countries can offer, and at the same time, these countries also gain access to favorable Chinese loans to build local mining companies.
5. In contrast to this approach, the EU is focusing on the forced greening of its economy, which, in addition to the war in Ukraine, is burdening European industry and making it less and less competitive.
6. According to the law on critical rare materials, at least 15 percent of materials must be recycled by 2030, at least 10 percent must be mined in the EU and at least 40 percent of the processing of these materials must be returned to Europe. As a result of the measures, no more than 65 percent of each component in each processing stage will come from third countries.

Based on this data, we can see that the EU is predestined to cooperate with China, however, its leaders are reluctant to grasp the urgency of this cooperation. That is why the import of electric cars could turn into a hotly debated topic in the EU. Weakening European competitiveness can be in the numbers as the number of Chinese cars exported to the EU increased rapidly until 2022 and the total volume amounted to USD 2 billion. As Chinese electric cars are on average 20 percent cheaper, this is just the beginning. The investigation into state subsidies launched by the European Commission leads us to believe that the outcome of the investigation will lead to countermeasures from the European side, most likely increases in import tariffs.[8] We believe this is a counterproductive strategy.

Looking at the possible state subsidies and their intensity is one way to protect the EU from external competition, the other way is to screen the foreign direct investments. We believe that both are legitimate instruments of economic development, but it is how these instruments are used that matters, as overuse of these instruments can lead to protectionism, which in the long run will not solve the problem of weakening European competitiveness. In this chapter, we take a brief look at the foreign FDI screening mechanisms introduced by the European Union and EU Member States.

**FDI screening mechanisms in the EU**

We should start with the fact that there is no uniform EU regulation on FDI screening. Moreover, FDI screening is the responsibility of the Member States. The above-mentioned

8 https://podcast.europeanchamber.com.cn/2023/11/22/22th-november-2023-compliance-conference-2023/

Regulation was adopted in 2018 and entered into force in April 2019[9]. The Regulation created a new coordination mechanism through which the European Commission and Member States can exchange information and raise concerns about specific investments where necessary. The EU has taken a liberal policy approach (compared to other OECD countries) in setting up the screening mechanism, which is more of a platform for cooperation between EU countries. Since the introduction of the framework, extensive comparative studies of national systems have been carried out. Although the EU regulation emphasizes procedural coordination and the strengthened role of the European Commission, the ultimate responsibility for FDI screening still lies with the member states. National FDI authorities implement the regulation differently, with some countries reporting more than others. Nonetheless, the regulation has prompted Member States to either create new national security screening frameworks or strengthen existing ones.

**Hungarian aspects**

In 2022, Chinese investment in Hungary took center stage as well-known players such as BYD, CATL, EVE Energy, Sunwoda Electronic, Semcorp, Huayou Cobalt, Zhejiang Hangke Technologies and others presented their investment and factory construction initiatives one after the other. The same applies to 2023 when the BYD's investment made the headlines. Two of the investments from the above list are worth highlighting:

1. CATL: The investment case we are dealing here with, is the investment of the Chinese CATL (Contemporary Amperex Technology Co.), which is one of the largest battery manufacturers in the world and has decided to invest in Eastern Hungary. According to the plans, the company will invest in a 7.3 billion euro battery factory in Hungary, the largest in Europe to date. Once the necessary permits have been obtained, construction of the 100 GWh plant will take no longer than 64 months. Once built, the factory will be able to produce batteries for Mercedes, BMW and Volkswagen.
2. BYD: The electric vehicle manufacturing landscape is becoming more and more comprehensive and is becoming a focal point for both European car manufacturers and East Asian battery manufacturers. This was probably the reason for BYD's decision to invest in Hungary. BYD sees Hungary as a strategic gateway to the European market and benefits from the emerging development of the supply chain in Hungary.

9 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R0452&from=EN

**Summary**

As we have seen in the briefing, the EU's attitude towards foreign direct investment has changed considerably in recent years. Whereas in the past the focus was on the added value of the investment, the profitability and the modernization effects of the investment, today geopolitical aspects dominate the assessment of the respective investment. It should therefore come as no surprise that the European Union is advising EU member states to create a stricter legal framework for the assessment of these investments.

A side effect of this change is that the EU's practice with regard to state subsidies is also changing. Only a few years ago, the European Commission began to focus on state aid from other third countries that distort the Single Market because, the Commission argued, subsidies from third countries appear to be increasingly causing negative or unfair competition in the Single Market. The excessive level of state subsidies and guarantees for Chinese and Russian companies entering the Single Market in large numbers between 2016 and 2019 has caused concern among Member States.

We have also looked at China’s position in foreign direct investment in the EU. We have concluded that China's position as a foreign investor in the EU has improved in recent years, but it is a far-fetched claim that it would dominate this market, let alone that it would be the most important investor. This statement applies to both acquisitions and greenfield investments. We also claimed that in the cases where Chinese companies enter the market, they are high-tech products. Two examples were briefly mentioned in the briefing: the direct investments of CATL and BYD in Hungary. Not only do these Chinese companies bring a considerable amount of capital and create thousands of jobs, these investments can also be considered high-tech investments.

We believe that the more the EU will focus on geopolitical considerations when considering direct investments, the more important those countries that pursue an ideology-free, pragmatic foreign and investment policy can become in this process. This approach is consistent with the fact that Hungary has become an important recipient of foreign direct investment in the automotive sector over the last three decades. Hungary therefore appears to be an excellent target for Chinese investment in the automotive sector.