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The EU–China Comprehensive Agreement on Investment: Lessons Learnt for Indonesia

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Abstract: *The European Union (EU) and China have recently reached an agreement: the EU–China Comprehensive Agreement on Investment (CAI). As one of the most recent investment agreements concluded by the EU, the paper aims to assess specific concessions made in the agreement, and provides lessons learnt for Indonesia on the ongoing negotiations of the Indonesia–EU free trade agreement, the Comprehensive Economic Partnership Agreement (IEU CEPA). The paper will present an overview of the main areas covered under the CAI, assess the potential impacts of the CAI on EU investment into Indonesia, and set out lessons that can be learnt from the CAI.*

Keywords: Investment agreement, FTA, China, European Union, Indonesia

JEL Classification: F, F13, F15, F21, F23

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1. Introduction

30 December 2020 marked a historical milestone for the European Union (EU) and China as they reached an agreement in principle on the EU–China Comprehensive Agreement on Investment (CAI). after 35 rounds of negotiations since February 2012. Nevertheless, it is unclear when the CAI will come into force despite the fact that it was originally expected to happen after 2022. This uncertainty is mainly because of the ongoing tension between the EU and China (Peel and Fleming, 2021).

Although some believe that the CAI would replace the existing bilateral investment treaties (BITs) between China and the EU member countries (Jones Day, 2021), the text of the CAI indicates otherwise. China has BITs with almost all of the EU member countries, except Ireland, for a total of 25 BITs. Despite having the CAI as an investment agreement, China and the EU will not terminate these existing BITs as Section VI of the CAI clarifies that previous agreements between the member countries of the EU/European Community and China are not superseded or terminated by the agreement. Thus, the BITs will remain in effect alongside the CAI, unless China and the EU member countries decide otherwise in the future.

Our paper aims to assess specific concessions made by the EU and China, and provides lessons learnt for Indonesia on the ongoing negotiations for the Indonesia–EU free trade agreement, the Comprehensive Economic Partnership Agreement (IEU CEPA). Section 2 presents a comprehensive overview of the main areas covered under the CAI. Section 3 assesses the potential impacts of the CAI on EU investment into Indonesia. Section 4 evaluates the state of the IEU CEPA negotiations and lessons learnt from the CAI. Section 5 concludes and offers policy recommendations.

2. The EU–China CAI: Commitments and Ratification

The CAI is not a free trade agreement (FTA) as it regulates investment rather than trade issues. It covers four traditional pillars of investment: liberalisation, protection, facilitation, and promotion. Based on its coverage, the CAI is similar to new generation international investment agreements (IIAs) such as the Association of Southeast Asian Nations (ASEAN) Comprehensive Investment Agreement (ACIA) or the investment chapter of the Regional Comprehensive Economic Partnership (RCEP). In this section, we will discuss the following areas regulated under the CAI: investment liberalisation, the regulatory framework, investment and sustainable development, and dispute settlement.

2.1. Investment Liberalisation

By December 2020, the cumulative European Union (EU) foreign direct investment (FDI) outflows to China had reached $166.7 billion over the last 2 decades. This number is expected to increase with one of the most cited achievements of the CAI – China's further investment liberalisation commitments (in the form of market access) which go beyond its commitments under the General Agreement on Trade in Services (GATS) mode 3 (commercial presence) both in terms of depth and breadth, as they not only liberalise market access in services but also goods, particularly manufactured goods. Many argue that the CAI will likely benefit EU investors in China, as the EU has already provided broad market access for Chinese investors (Allen and Overy Lang Yue, 2021; Dong, 2020). On the other hand, some argue that the CAI will provide marginal benefits, as a number of China's commitments under the CAI have already been provided by China's existing domestic rules and initiatives, including its Foreign Investment Law of March 2019, which entered into force on 1 January 2020. It is worth noting this does not necessarily make commitments under the CAI less significant, because China agrees to bind itself and cannot turn back on such commitments.

a. Market access

The CAI is a progressive agreement, as the parties agree to provide deeper market access. Both the EU and China maintain lists of non-conforming measures (NCMs) or reserved areas that are not subject to further liberalisation – in other words, a negative list. As such, sectors excluded from the negative list are open for investment. Table 1 illustrates the additional market access that EU investors may obtain through the CAI compared with China's existing economic agreements.

In line with the GATS, the CAI stipulates the parties' commitments (subject to each party's reservations) not to impose quantitative limitations (number of enterprises, value of transactions, assets, and output quantity) or an economic needs test on investors wishing to establish investments in the host state. The provision also requires parties not to restrict or require a specific type of legal entity or joint venture. These commitments may have quite a dramatic impact subject to the content of each party's negative list.

Table 1: Comparison of Market Access Offered by China Under Various Economic Agreements

Sector	General Agreement on Trade in Services (GATS)	Asia Pacific (RCEP) (signed on 15 November 2020)	US–China (Phase One Deal) (signed on 15 January 2020)	Additional market access for EU companies under the CAI
Manufacturing	Not covered	Below CAI	-	No
Autos/electric cars	Not covered	Below CAI	-	Yes, for electric cars
Financial services	Below CAI	Same as CAI	Same as CAI	No
Health	Below CAI	Below CAI	-	Yes, private hospitals in tier 1 cities
Telecommunications/ Cloud services	Below CAI	Below CAI	-	Yes, cloud services
Computer services	Below CAI	Below CAI	-	No
International maritime transport	Below CAI	Same as CAI	-	No
Air transport-related services	Below CAI (unbound)	Below CAI	-	Yes, computer reservation systems
R&D (in biological resources)	Not committed	Not committed	-	No binding future liberalisations

CAI = EU–China Comprehensive Agreement on Investment, EU = European Union, R&D = research and development, RCEP = Regional Comprehensive Economic Partnership, US = United States.
Source: European Commission (2021a).

b. *Prohibition of performance requirements*

Compared with the provisions of performance requirements contained in the World Trade Organization (WTO) Agreement on Trade-Related Investment Measures (TRIMs), the CAI provides deeper liberalisation as it prohibits parties from imposing certain requirements, such as export requirements, local content requirements, and transfer of technology. The provisions are applicable at the time of establishment as well as during operations.

This guarantee is important for EU investors, particularly because they will not be forced to transfer their valuable technology (which is potentially their main competitive advantage), and the government will not impose arbitrary requirements, hence providing more legal certainty. We note, however, that besides reservations, certain exceptions are applicable to the performance requirements discipline, hence foreign investors should closely look into these exceptions to understand better the extent of liberalisation and protection granted.

c. *Disciplines in relation to state-owned enterprises*

Chinese state-owned enterprises (SOEs) have been one of the main concerns for the EU during CAI negotiations, and certain disciplines on SOEs were deemed necessary to ensure equal treatment for EU investors. Chinese SOEs are large and highly capitalised. They also enjoy advantages in the form of subsidies or exclusive public procurements or bidding procedures in which foreign investors are simply excluded, such as the automotive sector or research and development (European Commission, 2013).

Similar to the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), the CAI contains provisions designated to discipline the parties' treatment of SOEs. The CAI does not use the term 'SOEs' in the agreement; it uses 'covered entity', which captures a wider scope of entities that may have the characteristics of SOEs. The disciplines are explained further below.

i. *Non-discriminatory treatment in relation to covered entities*

The CAI does not regulate the actions of covered entities directly, but it imposes an obligation on CAI parties to procure that the SOEs' commercial activities (purchasing or selling goods or services) are done based on commercial considerations rather than discriminatory considerations, i.e. the origin of the goods or the nationality of the service providers. The commitment does not apply if a covered entity of the host state makes purchases or sales of goods or services pursuant to an NCM adopted by the host state. The CAI also ensures that SOEs (the covered entities) are not given any special treatment and operate under the same conditions as foreign investors.

ii. *Transparency*

The CAI provides an opportunity for a CAI party that believes its interests are being adversely affected by the commercial activities of a covered entity of the other party to request in writing for the other party to supply information about the operations of the related entity. The scope of information that can be requested is extensive and some may even be sensitive in nature, hence a CAI party may be more inclined to encourage its covered entities to comply with the discipline.

d. *National treatment and most favoured nation treatment*

The CAI stipulates national treatment and most favoured nation (MFN) treatment obligations. These provisions not only liberalise investments by providing market access at the establishment stage, but also provide investment protection to foreign investors at the post-establishment stage. The MFN clause in IIAs has been a hotly debated topic (Batifort and Heath, 2018). A few IIAs have even excluded them altogether, as in the ASEAN–Australia–New Zealand FTA, India's model BIT, or the EU–Singapore Investment Protection Agreement (IPA). Similar to the EU's approach in its other investment agreements,[1] the MFN clause is maintained with certain clarifications and exceptions.

The CAI further clarifies that substantive provisions in other international agreements concluded by a party with a third country do not in themselves constitute treatment under the MFN clause. This means that the MFN clause cannot be used to import or incorporate substantive provisions from other investment agreements of any EU member countries or China *with a third country* into the CAI. The CAI also excludes

[1] See Canada–EU Comprehensive and Economic Trade Agreement, Chapter 8, Article 8.7(4); and EU–Viet Nam IPA, Article 2.4(5).

the incorporation of investor–state dispute settlement (ISDS) or other dispute settlement mechanisms into the CAI. Accordingly, CAI parties will have to use the dispute settlement procedure provided under the CAI, and no investor can *directly* file a claim of CAI breach against a party, as elaborated below in section 2.4.

e. Others: Investment facilitation and investment promotion

Certain other provisions are grouped into investment liberalisation, although their nature seems to be of facilitating or promoting investments. Investment promotion and facilitation actually go hand in hand, and measures that could be taken basically focus on removing ground level obstacles to investment (UNCTAD, 2017). One of the provisions prohibits the host state from requiring foreign investors to appoint natural persons of any particular nationality to senior management or board positions, so investors have full discretion in deciding their senior management or directors.

Another main provision is the facilitation of natural persons to obtain entry and temporary stays for the establishment of investments and intra-corporate transferees, although this provision does not guarantee the entry and stays of such natural persons. CAI parties retain their right to regulate in this regard. The provision requires a party not to impose any quotas or economic needs tests on the persons allowed to enter its territory as business visitors for establishment purposes or as intra-corporate transferees, and to grant them national treatment protection (Article XVII GATS applies *mutatis mutandis*) during their temporary stay in the host state. It also requires CAI parties to be transparent of the relevant measures.

2.2. Regulatory Framework

Despite not having the usual investment protection provisions (IPPs) contained in typical BITs or IIAs, the CAI continues to provide protection to foreign investors. This section explains the subsections contained in section III (regulatory framework) of the CAI – domestic regulation, transparency, and financial services.

a. Domestic regulation – licensing and qualification

This discipline is the closest to IPPs found in typical IIAs, i.e. fair and equitable treatment (FET). However, the protection is very specific and limited. CAI parties must ensure that their respective competent authorities do not act arbitrarily in issuing measures relating to licensing and qualification. Section III, Subsection 1, Article 2 of the CAI stipulates that the measures issued must be clear, objective, transparent, pre-established, made public in advance, and accessible. To a certain extent, this protection can be considered as a subset of FET protection where the competent authority of a host state should act in accordance with due process and in a non-arbitrary manner.

b. *Transparency*

Transparency is a discipline that appears across all sections of the CAI, and it may contribute to the promotion of investment (UNCTAD, 2012). The CAI obliges its parties to ensure that their laws, regulations, administrative guidelines, procedures, judicial decisions, and administrative rulings of general application in relation to any matter covered by the agreement be promptly published and made publicly available.

Besides the publication requirement, CAI parties also need to do public consultation regarding such laws and regulations. CAI parties shall ensure that administrative proceedings are done in a consistent, impartial, and reasonable manner. Accordingly, CAI parties must establish or maintain judicial, quasi-judicial, or administrative tribunals or procedures for reviewing or correcting final administrative actions on matters covered by the CAI. The CAI also obliges the host state to allow foreign investors to participate in the development of standards by its central government bodies (including related standardisation working groups and technical committees at all levels) on a non-discriminatory basis.

With regard to subsidies, the CAI does not strictly prevent CAI parties from granting them. However, it requires the parties to be transparent about the subsidies.

c. *Financial services*

CAI parties specifically regulate the disciplines for investment in financial services – insurance and insurance related services as well as banking and other financial services (excluding insurance). Essentially, the discipline requires CAI parties to ensure transparency and due process for the establishment of financial services. The CAI also obliges the parties to make best endeavours to ensure that international agreed standards for regulation and supervision and for the fight against tax evasion and avoidance in the financial services sector are implemented and applied in their respective territories.

Recognising the potential development of financial services, the CAI obliges the host state to allow foreign investors to supply any new financial service that it would permit its domestic investors to supply in similar situations, provided the new financial service does not require the adoption of a new law or the amendment of an existing law. However, this does not prevent a party from determining the institutional and legal form through which the new service may be supplied as well as the authorisation required for the supply, which can be refused only for prudential reasons.

2.3. Investment and Sustainable Development

The EU successfully negotiated a dedicated section on investment and sustainable development. In this section, we discuss the various commitments made pertaining to corporate social responsibility (CSR), environment, and labour. On CSR, CAI parties affirm their recognition of the importance of CSR, although the obligations in the CAI are limited to cooperation and promotion – agreement to promote responsible business practices and to exchange information and cooperate on promoting responsible business practices.

On environment, the CAI stipulates the commitment to strive to ensure that its laws and policies provide for and encourage high levels of environmental protection and strive to continue improving those laws and policies and levels of protection. It also highlights that it would be inappropriate to encourage investment by reducing the levels of environmental protection under their respective domestic laws.

On labour, the CAI requires the parties to ensure that their laws and policies provide for and encourage high levels of labour protection and continue improving those laws and policies and levels of protection. The CAI also seeks to prevent a race to the bottom by the derogation of labour laws to encourage investment. At the same time, the host state may not use labour standards for protectionist purposes or labour laws in a discriminatory manner. In addition, the CAI requires China to make continued and sustained efforts to ratify the fundamental International Labour Organization (ILO) Conventions No. 29 (Forced Labour Convention) and No. 105 (Abolition of Forced

Labour Convention), as well as other conventions that are classified as 'up to date' by the ILO.

2.4. Dispute Settlement

A dispute settlement mechanism (DSM) is intended to support the enforcement of obligations under international agreements. In most IIAs (including BITs), two types of DSM are commonly found: state–state dispute settlement (SSDS) and ISDS. Similar to the recently concluded RCEP, the CAI only provides for SSDS (CAI SSDS). This means that investors cannot directly bring a claim against a CAI party for breach of the CAI. If a host state breaches provisions of the CAI subject to SSDS, an affected investor could only request its home state to bring a claim against the host state, but the claim cannot be brought to the host state's courts or tribunals. The remedy from SSDS is limited to a recommendation that the breaching party should bring its inconsistent measures into conformity with the CAI, and this does not create any right to individuals.

Although there are many similarities between the CAI SSDS and the DSM in the WTO, the main differences are that the CAI SSDS (i) does not have a mechanism where panel reports must be adopted by a certain body consisting of all parties to the agreement; (ii) does not have an appeal mechanism; (iii) provides the option for the parties to voluntarily mediate at any time (by mutual agreement); and (iv) contains a forum selection clause that seeks to prevent parallel litigations if there is an equivalent obligation in another IIA to the obligation in the CAI.

Despite not having access to ISDS under the CAI, most EU investors in China will continue to enjoy access to ISDS under the existing BITs between China and individual EU member countries. Nevertheless, the scope of ISDS in some of those BITs is limited – only disputes with regard to the value of compensation in the event of expropriation.[2]

2.5. Exceptions Under the CAI

In line with the principle of the right to regulate, the CAI contains exceptions to preserve the parties' policy space in certain conditions. The exceptions include (i) general

[2] China–Poland BIT, Article 10; and China–Hungary BIT, Article 10.

exceptions; (ii) exceptions relating to capital movements, payments, or transfers; (iii) temporary safeguard measures; (iv) restrictions in case of balance of payments and external financial difficulties; (v) security exceptions; and (vi) taxation exceptions.

2.6. Ratification of the CAI

While CAI parties have reached an agreement in principle, the text of the agreement still has to be finalised (legal review and translation) before it can be submitted for approval by the European Council and the European Parliament. It is noteworthy that given that the CAI does not contain any ISDS, it is not a mixed agreement[3] that will require the approval of the European Parliament as well as the approval of the 26 member countries in their national parliaments, which involves 36 chambers (Conconi, Herghelegiu, and Puccio, 2021). The process of approving a mixed agreement is extremely complex, hence it is likely that CAI parties deliberately concluded this agreement without including any ISDS mechanism.

3. Potential impacts of the CAI on EU investment in Indonesia

Asian countries received $518 billion of FDI inflow in 2019, about one-third of the total global FDI. In 2019, it is estimated that China and Indonesia received 9.2% and 1.5% of global FDI flows, respectively (UNCTAD, 2020). Developing industrial economies in particular, such as China and Indonesia, have made an important contribution in attracting FDI in the past few decades by offering competitive labour costs and potential markets.

[3] A 'mixed agreement' means an agreement negotiated by the EU that includes provisions outside its exclusive competence (as regulated under Article 5 of the Treaty on European Union).

3.1. EU Investment in China and Indonesia

a. EU Investment in China

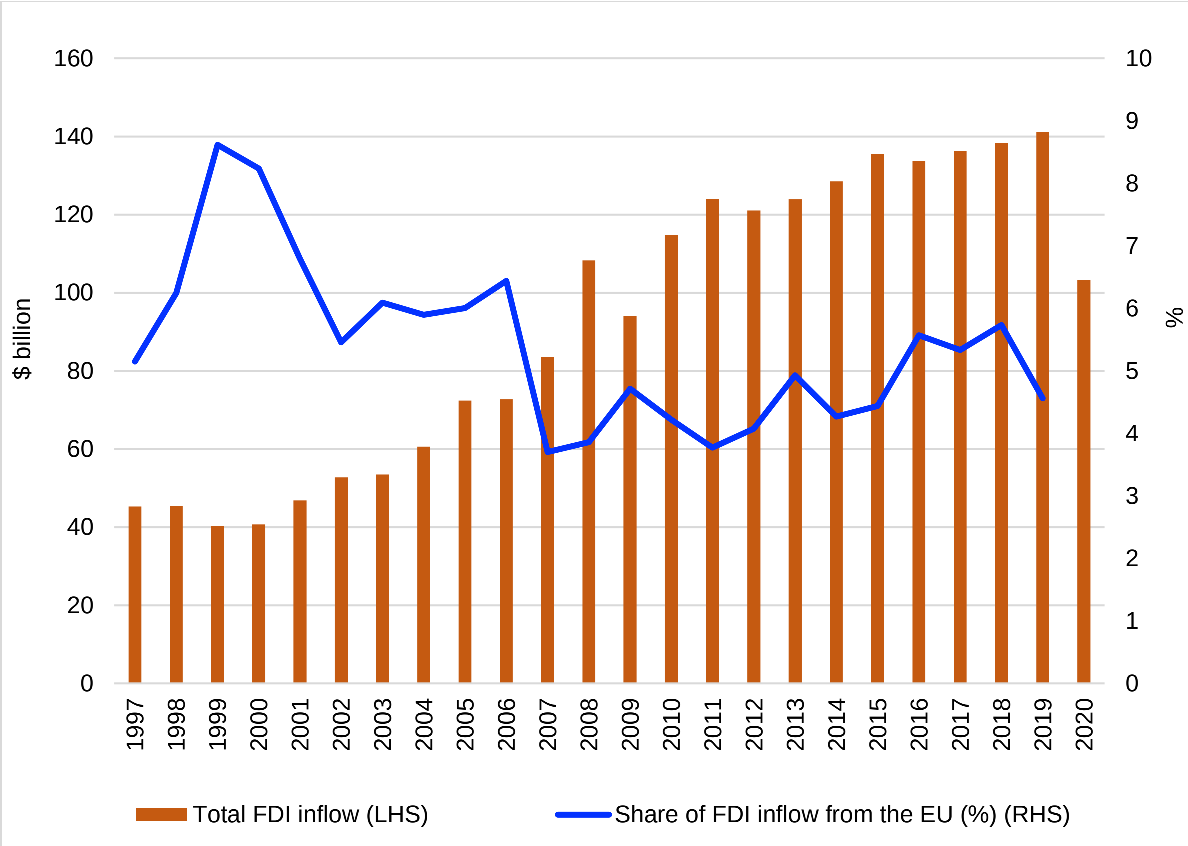
Figure 1 illustrates that in 2020, China recorded FDI inflows of $213 billion or 1.4% of its gross domestic product (GDP). In 2019, China absorbed FDI inflows of $141 billion – 9% of total global FDI flows or 27% of the total FDI flow into Asia. Over the past decade, FDI inflows to China have grown by an average of 2.4% year on year.

By far the largest source of FDI to China in the past 5 years is Hong Kong (66%), followed by Singapore (6%). The EU was in third position, contributing 5% of total FDI inflows to China. In 2019, China recorded $6 billion of FDI inflow from the EU, 22% less than the previous year. Figure 1 shows the shares of EU FDI inflows to China. China's FDI inflow from the EU recorded average year-on-year growth of 4%. The United Kingdom, which recently left the EU, was the third largest European source of Chinese FDI in 2019, contributing 14% of the total EU27 FDI in China in 2019.

About two-thirds of China's FDI inflow in 2019 took place in four sectors: manufacturing (25%), real estate (17%), leasing and commercial services (16%), and information transmission and computer- and software-related services (10%). While still absorbing the largest FDI, the contribution of FDI in the manufacturing sector to total China's FDI inflow has been steadily declining over the past two decades, falling from 71% in 2004 to 42% by 2011 and merely 25% by 2019. This phenomenon corresponds to the continual rise in labour costs in China and the relocation of low-cost manufacturing to other developing countries.

Manufacturing's most prominent role in attracting FDI to China is being replaced by other emerging sectors, particularly high-skilled services. One such sector is information transmission, computer services, and software, which is the second fastest growing sector in terms of FDI inflow in the past 5 years, with 58% average annual growth in this period. This sector quintupled its contribution to total FDI inflow in China from 2% in 2014 to 10% by 2019 and even managed to record a further 11% growth in FDI during the pandemic year of 2020. Another increasingly popular destination for FDI into China is leasing and commercial services, whose share to China's total FDI inflow grew from 6% in 2010 to 16% by 2019.

Figure 1: China's FDI Inflow and Share of FDI Inflow from the EU, 1997–2020



EU = European Union, FDI = foreign direct investment.
Note: The 2020 figure represents the value at the end of the third quarter.
Source: China's Ministry of Commerce (2021), Statistics of Foreign Direct Investment in China. http://english.mofcom.gov.cn/article/statistic/foreigninvestment/ (accessed 3 March 2021).

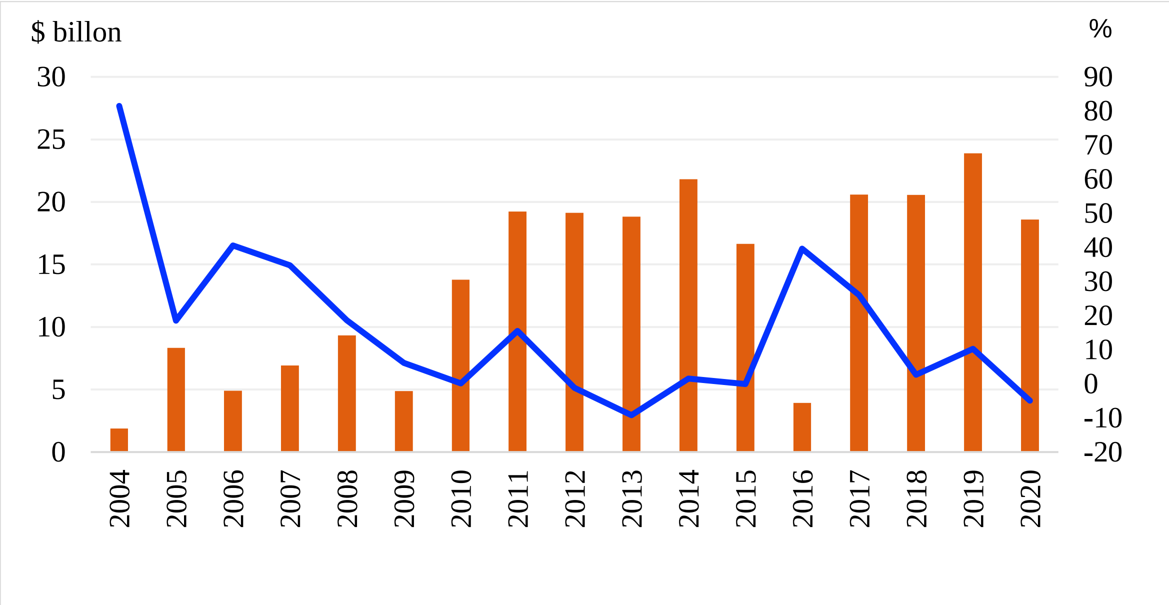
b. EU Investment in Indonesia

Figure 2 shows that since 2004, Indonesia has consistently recorded positive net FDI inflows. In 2020, Indonesia recorded net FDI inflow of $18.6 billion or 1.8% of GDP. Over the past decade, net FDI inflow has ranged from 1% to 3% of GDP and averaged 2.1%. It has remained relatively stagnant ever since, with only 0.2% average growth since 2014. By 2020, Indonesia had amassed total inward FDI stock of $311 billion (29% of GDP).

The five largest contributors of FDI inflow to Indonesia in the last 5 years (2015–2020) were Singapore (45%) and Japan (26%), followed by the EU (10%), China (8%), and Hong Kong (7%). In 2020, however, Indonesia recorded a negative net FDI inflow of $922 million from the EU. It is worth noting that the United Kingdom, which recently left the EU, was the second largest European source of FDI inflow in Indonesia – responsible for 35% of Indonesia's FDI inflow from the EU over the past 5 years.

In the past 3 years, manufacturing has absorbed about 43% of total FDI in Indonesia, against 15% for agriculture, forestry, and fishing, and 14% for wholesale and retail trade. In the manufacturing sector, metals, chemical and pharmaceutical, and food and beverages are the three biggest beneficiaries of FDI inflows, and together absorbed 64% of Indonesia's total FDI inflows in the sector. FDI inflows from the EU since 2016 have been largely absorbed in manufacturing ($4.4 billion); mining and quarrying ($2.8 billion); and electricity, gas, and water supply ($1.3 billion).

Figure 2: Indonesia's Net FDI Inflow and Share of FDI Inflow from the EU, 2004–2020



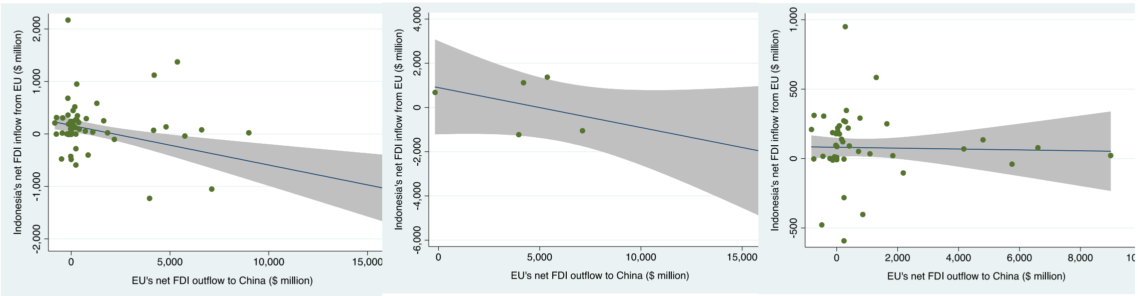
EU = European Union, FDI = foreign direct investment.
Source: Bank Indonesia (2021), Indonesian Economic and Financial Statistics (SEKI). https://www.bi.go.id/id/statistik/ekonomi-keuangan/seki/Default.aspx#headingFour (accessed 2 February 2021).

3.2. How the EU–China CAI May Affect EU Investment in Indonesia

We briefly examine if there are such correlations between EU investment, particularly FDI inflows into China and Indonesia. We use simple statistical exercises (with detailed data sources and sectoral harmonisation in the appendix) of correlations and cross-correlograms.

Figure 3 indicates a negative correlation between the EU's net FDI outflow to China and Indonesia. This negative relationship is observed more clearly in the manufacturing sector, while FDI in the services sectors of both countries does not exhibit a noticeable pattern of correlation.

Figure 3: Correlation of EU FDI Outflows to China and Indonesia, 2013–2018



Total Manufacturing Services

EU = European Union, FDI = foreign direct investment.

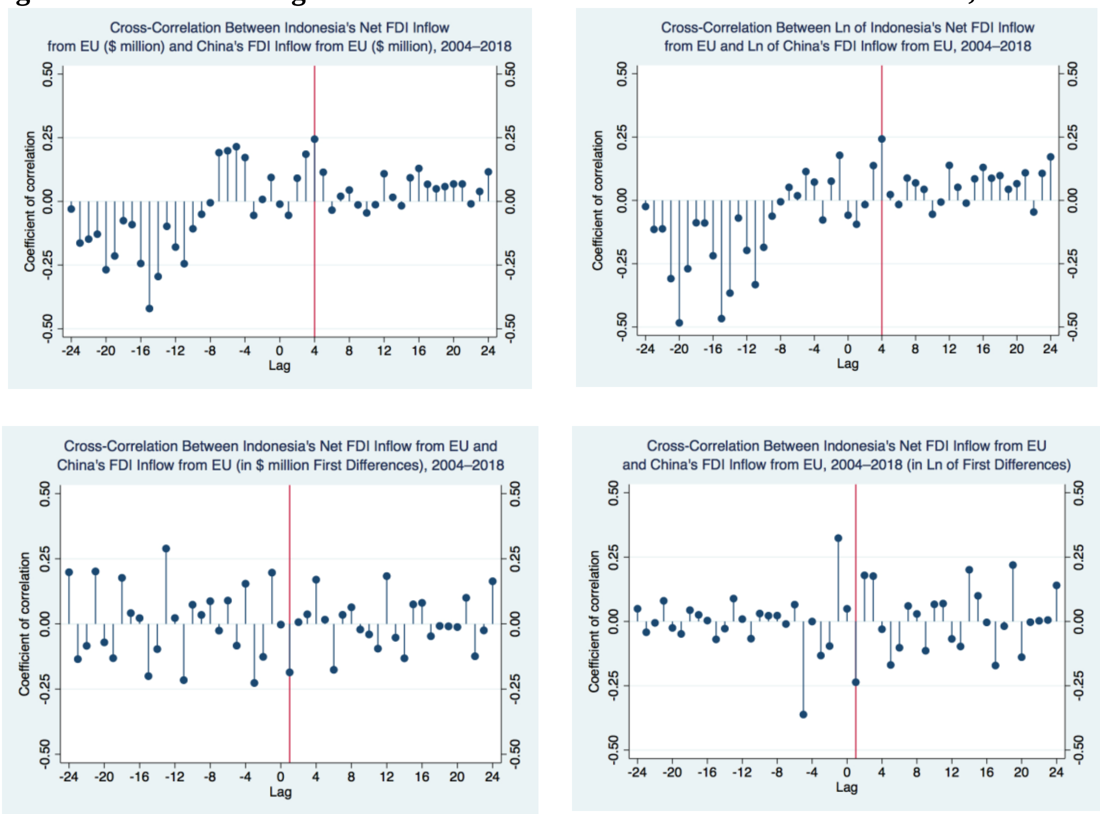
Source: Authors' calculations, based on data on the EU net FDI outflow to China from Eurostat and data on the EU net FDI outflow to Indonesia from SEKI, Bank of Indonesia. The data from these sources are available across sectors, but for China are only available from 2013 to 2018.

To have a more detailed picture, we use quarterly investment data from 2004 to 2018 and take the lagged value of investment. Figure 4 presents cross-correlograms which show that greater height/depth (i.e. closer to |1|) represents stronger correlations, and the lag with the strongest correlation is marked with a red line. The finding suggests that the EU FDI outflows to China at time *t* are most strongly (and in this case positively) correlated to the EU FDI outflows to Indonesia at time *t*+4 quarters, or a full year later. In general, coefficients of correlation in the medium to long run at a 12 quarter-lag or more (3 years or more) are mostly dominated by positive, although very small, values.

While we find initial negative correlations between the EU FDI outflows to China and the EU FDI outflows to Indonesia, particularly in the manufacturing sector, in the medium and long run (particularly after 3 years or more), the EU FDI outflows to China show positive correlations to the EU FDI outflows to Indonesia.

Considering the limited available data across sectors, it is worth noting that this simple empirical exercise cannot establish or rule out the possible investment creation or diversion that might happen as a result of the recently concluded EU–China CAI, and the full consequences of that agreement remain to be seen.

Figure 4: Cross-Correlogram of EU Net FDI Outflows to China and Indonesia, 2004–2018



EU = European Union, FDI = foreign direct investment.
Source: Authors' calculations, based on data on the EU net FDI outflow to China from China's Ministry of Commerce and data on the EU net FDI outflow to Indonesia from the Central Bank of Indonesia. The data from these sources are available as quarterly data from 2004 to 2018.

4. CAI: Lessons Learnt for Indonesia

This section reviews rules contained in the CAI and evaluates how they may affect the ongoing IEU CEPA negotiations, particularly the types and depths of commitments that the EU may expect from Indonesia and the implications of such commitments for Indonesia. This section comprises the following subsections: an overview of the EU–

Indonesia investment relationship, the status of the ongoing IEU CEPA negotiations, and particular areas of concern for Indonesia.

4.1. EU–Indonesia Investment Relationship: An Overview

Indonesia and the EU previously entered into a framework agreement on comprehensive partnership and cooperation in 2014. On a bilateral level, Indonesia has had BITs with several EU member countries although most of them have been terminated in line with Indonesia's policy of replacing its outdated BITs (Ewing-Chow and Losari, 2014). As of March 2021, the only remaining BITs are with Denmark, Czech Republic, Finland, Poland, and Sweden (UNCTAD, 2021).

4.2. IEU CEPA negotiations

The IEU CEPA negotiations were launched in July 2016, and there have been 10 rounds of negotiations as of March 2021. The EU aims to achieve a high level of liberalisation in the IEU CEPA, particularly in non-tariff barriers in trade in goods. The European Commission identifies the need to address particular limitations to national treatment and foreign equity caps in place in Indonesia. It shares the view of the EU–Indonesia FTA sustainable impact assessment that ambitious results on investment liberalisation and public procurement would be instrumental in maximising the benefits of the agreement for business. In particular, the European Commission seeks to address regulatory barriers in the financial services, renewable energy, and waste management sectors (Development Solutions, 2019).

The European Commission also wants to have IPPs, which ensure a high level of protection for investors and their investments and at the same time preserve the parties' right to pursue legitimate public policy objectives such as the protection of health, safety, or the environment. The protection standards should 'not protect investor's expectation of profits' as a way to balance investment protection and the state's right to regulate (European Commission, 2020). Regarding ISDS, the EU proposes the Investment Court System (ICS), which is a main feature of the EU reformed approach to investment protection. The ICS aims at ensuring 'consistency and predictability, high guarantees of independence and impartiality by the adjudicators, and transparency of the proceedings' (European Commission, 2020).

Unlike the CAI, the agreement that the EU aims to conclude with Indonesia is an investment agreement with similar coverage to the EU–Singapore IPA and the EU–Viet Nam IPA. In December 2016, the EU submitted its proposal for a legal text on trade in services and investment in the IEU CEPA. Its chapter on investment contains the following sections: liberalisation of investments, investment protection, and resolution of investment disputes and the ICS.

Our assessments will be limited to the proposed text of the IEU CEPA, as no further updates have been made publicly available. According to the report prepared by the EU for the 10th round of negotiations, discussions on IPP are focused on the coverage of subsidies, expropriation, observance of written commitment, and denial of benefits. Discussion is also ongoing as regards ISDS, which focuses on cost allocation and the European Commission's proposals on transparency in the proceedings.

4.3. Areas of Concern for Indonesia

This section discusses in greater detail the commitments that the EU may expect from Indonesia in the IEU CEPA investment chapter, based on the investment and trade in services (ITS) chapter of the proposed text as well as the CAI and the EU–Viet Nam IPA. The authors will then analyse those commitments and their impacts. Notably, some investment-related matters in the CAI are not regulated in the investment chapter of the proposed text, but in other separate chapters. However, the authors will briefly analyse these for completeness.

a. Investment liberalisation

Investment liberalisation is one of the main priority areas for the EU in the negotiations. In fact, it appears to be the main driver for the EU in the CAI as it opens up market access for EU investors to establish investments in China. In the China–EU investment relationship, there are sizeable mutual FDI flows. In contrast, FDI mainly flows from the EU to Indonesia as not many Indonesian companies expand their businesses in the EU. Indeed, Indonesia is a capital importing country that relies on FDI as one of the main drivers of economic development (Damuri et al., 2015). Accordingly, Indonesia has an interest in obtaining more FDI from the EU to boost its economy, and one of the ways to attract more FDI is to liberalise further.

The Government of Indonesia under the President Joko Widodo administration recognises the need for FDI and has undertaken unilateral liberalisation through the enactment of Law No. 11 of 2020 on Job Creation on 2 November 2020 (the Omnibus Law), which also amends Law No. 25 of 2007 on Investment (the Investment Law). Foreign investors' access to economic activities in Indonesia was regulated by Presidential Regulation No. 44 of 2016 (commonly known as the Negative Investment List), which sets out sectors that are opened, closed, or restricted for foreign investment. With the Omnibus Law, a new investment list was issued under Presidential Regulation No. 10 of 2021 (PR 10/2021) regarding Investment Sectors (the New Investment List) and replaced the Negative Investment List with a more liberalised list of investment sectors, including a significant decrease in the number of business fields with restrictions for foreign investors from 350 business fields to a mere 46 business fields.

The authors will address each discipline relating to investment liberalisation, as seen in the CAI and the proposed text.

i. *Market access*

Although Indonesia has recently improved market access for foreign investors, such unilateral concessions do not bind the current government or future governments. Hence, the EU will likely negotiate for market access liberalisation to be recorded in the IEU CEPA. Similar to the CAI, Article 2.2(2) of the proposed text's ITS chapter also stipulates the commitment to eliminate certain quota restrictions.

The EU appears to be interested in further market access in financial services, renewable energy, and waste management. These sectors do not appear to be on the list of business activities that are open with certain restrictions in the New Investment List, hence they may not necessarily raise concern for Indonesia. Some other potential priority sectors for the EU include higher education (universities); vocational education; tourism; hospitals; insurance; mining and energy (KADIN Indonesia, APINDO, and EuroCham, 2017); infrastructure; chemicals; food; metal; manufacturing; services (banking, express delivery, logistics, and construction); and horticulture (Vision Group, 2011; Eurocham, 2020). If Indonesia believes that certain policy space is required in these sectors, it can take the CAI's approach and make a list of NCMs (negative list approach). Alternatively, it can use the EU–Viet Nam's FTA approach (chapter 8) found in the proposed text, which is essentially a hybrid approach in which each party lists the sectors in which it makes market access commitments and includes reservations for relevant sectors. Subject to the length of the list of NCMs, the negative list approach may be a more ambitious approach in liberalising investment.

If a negative list approach is going to be used, Indonesia should be aware of a potential proposal from the EU of including a ratchet clause through which one party would commit to future liberalisation if the party unilaterally decides to open up market access in specific sectors by amending its national law (e.g. Indonesia's New Investment List). In addition, if Indonesia commits to extend MFN treatment to the EU at the establishment stage, it must grant EU investors the same market access as what it grants to its other FTA partners, including under the ACIA.

ii. *Performance requirements*

Requirements for foreign investors to operate in a certain way are often imposed by the host state as part of its economic policies (CITI, 2017). The proposed text contains a similar performance requirement provision as Section II, Article 3 of the CAI and Article 8.8 of the EU–Viet Nam FTA. In fact, some of these performance requirements are found in the Japan–Indonesia Economic Partnership Agreement, but the CAI goes further, in particular prohibiting certain requirements relating to technology.

Indonesia has used performance requirements to promote the use of domestic products and encourage foreign investors to set up more downstream production facilities in Indonesia, e.g. local content requirements in the pharmaceutical sector (requirements for raw materials and research and development) (Anggraeni, 2020); the telecommunications sector (e.g. requirements for 4G-capable smartphones sold in Indonesia – both hardware and software) (CITI, 2017: 5); and the mining sector (requirement to process or refine certain raw materials prior to export).

A performance requirement provision in the IEU CEPA does not necessarily prohibit Indonesia from imposing any performance requirements, provided that they are set out in its schedule of reservations (NCMs). However, once Indonesia makes commitments, the measures in breach of such commitments are subject to SSDS (not ISDS). Indeed, Indonesia had an experience where its national car programme was brought to the WTO and declared to be in breach of Article 2.1 of the TRIMs Agreement (WTO, 1998).

iii. *SOEs*

Indonesian SOEs are not as large as Chinese SOEs in terms of capitalisation, but it appears that the EU also wants rules over SOEs to be included in the IEU CEPA. In 2015, the Indonesian government's ownership of SOEs made up 32.31% of its total assets in its annual financial statement), and they received support in the form of capital injections (Nugroho, 2019).

The obligations in the CAI, the EU–Viet Nam FTA, and the proposed text are largely similar (e.g. non-discrimination, commercial considerations, regulatory framework and enforcement, as well as transparency), with certain differences in the scope and the relationship between an SOE and a regulatory body.

Indonesia should conduct a comprehensive study on its SOEs, including a mapping of its SOEs and the support measures that they enjoy. If certain support measures are indispensable for specific SOEs, Indonesia should negotiate to include such NCMs in its reservation list. It should also ensure that its SOEs comply with the obligation to conduct sales and purchases in accordance with commercial considerations. Indonesia could also potentially negotiate a higher threshold for the discipline on SOEs.

iv. *Investment facilitation and promotion*

Similar to the CAI, the proposed text contains the discipline on facilitating the entry and temporary stay of natural persons to set up investments and to work as intra-corporate transferees. However, the EU proposes that such facilitation should be extended to business sellers, contractual service suppliers, and independent professionals. This potentially brings in competition for service providers and professionals in Indonesia. While it may be useful for the purpose of transfer of knowledge in certain areas where there is a shortage of service providers and professionals, a more detailed assessment and identification of sectors will be critical before Indonesia makes any commitments. Indonesia should consider conducting public consultation with the service suppliers and professionals (e.g. technology and finance) in relevant sectors to have a better understanding of the landscape.

b. Regulatory framework

i. <u>Domestic regulation – licensing and qualification</u>

Compared with the CAI, the proposed text has a broader scope as it covers measures relating to licensing and qualification requirements and procedures that affect the cross-border supply of services; and does not include an exception to applications for and extensions of visas, residence permits, and work permits.

Similar to the CAI, the discipline in the proposed text essentially aims to facilitate foreign investment by providing foreign investors with accessible and transparent information, and certain due process guarantees during their establishment process. Over the last couple of years, Indonesia has improved the application procedures for the establishment of foreign investments as seen in its improved ranking on the World Bank's Doing Business Index in 2020 (73 out of 190). If Indonesia seeks to make commitments in this discipline, it should continue improving its bureaucracy (including by investing in technology) and ensure that regulators at all levels are aware of such commitments.

ii. <u>Specific services</u>

Unlike the CAI, which only contains further regulation regarding financial services, the proposed text sets out further disciplines for several services which appear to generate the most interest from EU investors – delivery, telecommunications networks, financial services, and international maritime transport services.

Similar to the CAI, the discipline for financial services in the proposed text requires the parties to ensure transparency and due process for the establishment of financial services suppliers. It also includes a specific provision (in the ITS chapter) regarding new financial services which has further investment liberalising potential or a ratchet mechanism. It is important for Indonesia to consider this because regulations often take some time to be passed, hence such provision may provide market access for new financial services.

c. *Sustainable development*

Sustainable development is an important part of the IEU CEPA. Unlike the CAI, which only covers investment and sustainable development and a limited scope of topics, the IEU CEPA will likely cover a broader scope, similar to the EU–Viet Nam FTA which contains a dedicated chapter on trade and sustainable development.

Some of the main challenges that Indonesia may face during the negotiations include the EU's strict environmental laws in relation to forest fires caused partly by palm oil plantation (Eurocham, 2020). The proposed text covers commitments on the effective implementation of multilateral environmental agreements and provisions relating to the fight against climate change, conservation and sustainable use of biological diversity, sustainable forest management, conservation of forest cover, and sustainable management of fisheries and aquaculture. While these are important subjects, Indonesia must carefully consider its ability to comply with these commitments and request capacity building and sharing of best practice from the EU.

d. *Investment protection and dispute resolution*

Unlike the CAI, which only contains limited IPPs with no ISDS, the EU and Indonesia appear to be negotiating IPPs and ISDS for the IEU CEPA. Although the 2016 proposed text appears to include IPPs and ISDS as part of the whole CEPA, this approach may change in light of the Court of Justice of the European Union decision regarding the EU–Singapore FTA in 2017. Following the decision, the EU–Singapore FTA and the EU–Viet Nam FTA have separate IPAs with ISDS. The approach was taken to allow the trade agreements to enter into force as soon as possible without having to wait for each EU member country to complete its ratification of the IPAs. The same approach may be more favourable for the IEU CEPA.

Given that the CAI does not contain elaborate substantive IPPs and ISDS, as found in many IIAs, it cannot be an inspiration for Indonesia's negotiation of the IPPs. Unlike the CAI, which provides that the parties will negotiate an IPA separately, the EU may push for simultaneous conclusion of an investment agreement and a trade agreement because only five EU member countries currently have BITs with Indonesia compared with the 25 BITs they have with China. Hence, the EU has the incentive to ensure that EU investors obtain investment protection, and at the same time terminate the five BITs.

i. *IPPs*

The IPPs in the proposed text are generally similar to those found in the EU–Viet Nam IPA, but the latter has been refined. Therefore, the authors will look at the EU–Viet Nam IPA as an inspiration for the IEU CEPA. Essentially, the proposed text's ITS chapter represents a modern and refined IIA with a clearer scope of protection, e.g. similar FET standard as found in Article 2.5(2) of the EU–Viet Nam IPA. Similar to the EU–Viet Nam IPA, the MFN clause in Article 2.4(4) of the proposed text's ITS chapter has a limited scope, hence foreign investors cannot import substantive obligations from other IIAs into the agreement.

Unlike old BITs, Article 2.2(1) of the EU–Viet Nam IPA and Article 1.1(2) of the proposed text's ITS chapter also expressly affirm the parties' right to regulate within their territories to achieve legitimate policy objectives. This provision addresses countries' concern about potential regulatory chill due to potential claims brought by affected foreign investors. Further preservation of policy space is done by including various exceptions in the agreement. Indonesia should ensure that such exceptions are applicable to the investment chapter of the IEU CEPA.

ii. *ISDS*

As an enforcement mechanism of the IPPs, the EU also seeks to have an ISDS mechanism in the IEU CEPA, as can be seen in Chapter II, Section C of the proposed text's ITS chapter. The existence of an ISDS mechanism may contribute to the rule of law in a host state and may even become an instrument for investment promotion and facilitation (Kriebaum, 2015; Bayhaqi and Mann, 2019). The EU proposes the ICS rather than traditional party-appointed tribunals.

The scope of the ICS in the proposed text's ITS chapter is similar to that under the EU–Viet Nam IPA. However, the MFN clause in the proposed text indicates the EU's proposal to extend MFN to the establishment stage. If this happens, it means that the scope of the ICS will be wider than under the EU–Viet Nam IPA and will result in allowing access to investors to the ICS for alleged breach of MFN at the establishment stage. This is something that may not be favourable to Indonesia, hence Indonesia should carve out such a commitment as it did under the ACIA.

The ICS has been adopted in the EU–Singapore IPA, the EU–Viet Nam IPA, and the EU–Canada Comprehensive Economic and Trade Agreement (EUC–CETA). It is a permanent and multilateral system of ISDS that consists of a Tribunal and an Appellate Tribunal (similar to the Appellate Body in the WTO, the Appellate Tribunal reviews decisions rendered by tribunals). With such a structure, the ICS is meant to address some of the criticisms against the current ISDS found in most IIAs, including lack of transparency, consistency, and impartiality of arbitrators. Many commentators have analysed the ICS (Li, 2018; Brower, 2018; Alvarez, 2020; Chaisse and Vaccaro-Incisa, 2018; Lévesque, 2016), but it has yet to be tested. Related to this, the EU has also proposed a standing multilateral investment court to the United Nations Commission on International Trade Law (UNCITRAL) Working Group III for further discussion (UNCITRAL Working Group III, 2019). A comprehensive analysis of the ICS is beyond the scope of this paper. However, under Article 2.27(2) and (12) and Article 2.28(2) and (12) of the proposed text's ITS chapter, Indonesia will have to contribute a certain amount on a monthly basis to pay the retainer fees of judges and members of the appeal tribunal who are appointed on a 6-year term. This can be quite costly in the long term; hence, Indonesia should also consider this point prior to agreeing to such a system.

5. Policy Recommendations and Conclusion

The conclusion of the CAI negotiations in December 2020 was definitely a highlight in international economic law, particularly amidst the ongoing pandemic. There are many expectations that the CAI will bring economic benefits to both China and the EU, while at the same time it acts as a political statement for China. Nevertheless, it remains to be seen whether the CAI will eventually enter into force as ratification processes on both sides are still ongoing.

As US–China trade tensions do not show signs of easing soon and the ongoing pandemic continues, businesses are rethinking the structure of supply chains to ensure resilience when they face similar situations in the future. Hence, businesses have started to think about diversification of their supply chains and ways to manage them (Baker McKenzie, 2020: 11). As such, Indonesia could potentially use the IEU–CEPA to tap into these potential investments.

The CAI and the EU–Viet Nam IPA present some lessons for Indonesia's negotiations of the IEU CEPA, as the authors highlight below:

5.1. Structure of the Agreement

The IEU CEPA aims to have comprehensive trade in goods, trade in services, and investment agreements. In light of the Court of Justice of the European Union's decision regarding the European Commission's competence, the EU and Indonesia may consider taking a similar approach to the EU-Singapore and the EU–Viet Nam FTAs negotiations – to conclude separate trade and investment agreements. This will allow the trade agreement to enter into force more swiftly, hence the parties could start enjoying its benefits.

5.2. Investment liberalisation

Given the expected ambitious level of liberalisation that the EU seeks, Indonesia should conduct a comprehensive stock-taking of its NCMs, especially those relating to market access, performance requirements, and support measures for SOEs. If Indonesia does not believe that it is ready to liberalise a particular sector or seeks to impose certain requirements in a particular sector, it should include it in its list of NCMs. It should also be aware of the implications of including a ratchet clause and an MFN treatment commitment at the establishment stage. As regards the SOE discipline in the proposed text, Indonesia should be aware that once the commitment has been made, it should ensure that its SOEs comply with the obligation.

In addition, Indonesia should conduct a mapping of service suppliers and professionals in Indonesia that will be affected by competition if it facilitates the entry and temporary stay of EU nationals, as well as sectors that may benefit from such facilitation due to a shortage or lower level of skills in the country. Any breach of these investment liberalisation commitments may result in a dispute being brought by the EU to SSDS.

5.3. Domestic regulation

In light of the obligations in relation to licensing and qualification procedures and requirements, Indonesia should continue to improve the bureaucracy and invest in technology to provide information online and process applications electronically. The proposed text also contains certain disciplines for selected sectors which are important to note. In particular, Indonesia should carefully consider the provision on new financial services, which has a liberalisation effect. If Indonesia wants to preserve its policy space as regards new financial services, it should carve out or limit the application of such a provision.

5.4. Sustainable development

Under the proposed text, sustainable development is linked to both trade and investment. Accordingly, Indonesia should also consider the trade aspect of the commitments it takes in the chapter, particularly in light of the ongoing dispute in the WTO over the EU's measures on Indonesian palm oil products. Palm oil may become one of the discussion points given the EU's concern over the environmental impacts of palm oil plantations in Indonesia. In any event, Indonesia should request capacity building and sharing of best practice from the EU in relation to sustainable development issues.

5.5. Investment protection and ISDS

The proposed text essentially contains modern and refined IPPs that strike a better balance between investment protection and the state's right to regulate. States may issue measures to pursue legitimate policy objectives without being subject to disputes from affected investors. First, with regard to the ICS proposed by the EU, Indonesia should carve out the applicability of the system to MFN treatment commitment at the establishment stage. Second, while the ICS seems to address many concerns raised by commentators and states in relation to the traditional ISDS by party-appointed tribunals, its efficiency is yet to be tested. Third, Indonesia should consider the costs that may be incurred by signing up to the ICS given the requirement to contribute to the payment of retainer fees of the judges and appellate body members on a monthly basis. Fourth, Indonesia could propose SSDS in the IEU CEPA, as what the EU–China has in the CAI.

Overall, the IEU CEPA is expected to be beneficial to both Indonesia and the EU, especially in attracting more FDI from the EU to Indonesia, and will contribute to the country's economic development. However, Indonesia should conduct a comprehensive study and careful assessments, particularly in sectors that are important for the Indonesian economy, as once Indonesia makes commitments under the agreement, it will be very difficult to retract those commitments without legal consequences.

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Appendix

Table A1: FDI Data for Indonesia and China

Country	Variable	Source	Frequency	Range	Remark
China	China's FDI inflow (utilised)	Ministry of Commerce	Quarterly	2003–2020	Not EU-specific
	EU's net FDI outflow to China	Eurostat	Yearly	2013–2018	Limited observations
Indonesia	Net FDI inflow from EU	Bank Indonesia	Quarterly	2004–2020	EU-specific by sector
	Foreign investment realisation	BKPM	Quarterly	2003–2020	Not EU-specific
	EU's net FDI outflow to Indonesia	Eurostat	Yearly	2013–2018	Limited observations

BKPM = Indonesian Investment Coordinating Board (Badan Koordinasi Penanaman Modal, BKPM), EU = European Union, FDI = foreign direct investment.
Source: Authors' compilation.

Table A2: Sectoral Harmonisation Data from the Central Bank of Indonesia, Chinese Ministry of Commerce, and Eurostat

Bank Indonesia	China's Ministry of Commerce	Sector code	Harmonised sector description
Agriculture, hunting, and forestry Fishing	Agricultural	1	Agriculture, hunting, forestry, fishing
Mining and quarrying	Mining	2	Mining and quarrying
Manufacturing	Manufacturing	3	Manufacturing
Electricity, gas, and water supply	Electricity, gas, and water production and supply	4	Electricity, gas, water supply
Construction	Construction	5	Construction
Wholesale and retail trade; repair of motor vehicles, motorcycles; and personal and household goods	Wholesale and retail trade	6	Wholesale and retail trade
Hotel and restaurant	Accommodation and catering trade	7	Hotel and restaurant
Transportation, storage, and communication	Transport, storage, and postal service Information transmission, computer service	8	Transportation, storage, information, communication
Financial intermediation	Financial intermediation	9	Financial intermediation
Real estate, renting, and business activities	Real estate Leasing and commercial service	10	Real estate, renting, business activities
Education	Education	11	Education
Health and social work Other community, social, and personal service activities Others	Health care, social security, and welfare Scientific research, polytechnic service Water conservancy, environment, and public utility management Resident and other services	12	Other services

Source: Authors' compilation of sectoral harmonisation.

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