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CHINA'S GROWING IMPORTANCE FOR GERMAN INVESTMENT

RAINER FREY*¹

China's role in the world

The economic opening-up of China began in the late 1970s, and since the start of the 1990s the country has been an important location for investment and a trading nation on a global scale. China's integration into the world markets resulted in rapid growth of its economy, which, according to official Chinese sources, increased the country's real gross domestic product by an average of 8½ percent a year between 1995 and 2004. The process has also resulted in China now being the seventh-largest economy in the world in terms of GDP. Even so, per capita GDP is still relatively low owing to China's enormous population.

Foreign direct investment in China has also grown dramatically. While China, according to IMF figures, had FDI inflows of just slightly more than \$4 billion in 1991, they had almost reached \$30 billion in 1993. More FDI has flowed only into the United States in the past. In 2003, China actually was the most attractive location (apart from Luxembourg) for foreign capital investment, at \$54 billion.² In 2003, Hong Kong, at just under \$18 billion, became the largest investor on the Chinese mainland.³ It was followed, by a wide margin, by Japan and the United States, whose investment was much the same as that of

Europe (China Statistical Yearbook 2004). Regarding trade, China has attained great significance in a relatively short time. For example, China now accounts for almost 6½ percent of world trade. There is also a direct link between China's direct investment and Chinese foreign trade: over half of China's exports in 2002 were attributable to the subsidiaries, participating interests and joint ventures of foreign firms (IW 2004).

China's attractiveness as an investment location is due primarily to the favourable production conditions, notably the very low labour costs, and to the enormous size of its domestic market that is in the throes of development and offers a promising future. The high growth rates of China's GDP, which are far above those of most industrial countries, and a population of more than 1 billion people arouse expectations of substantial sales prospects of foreign producers. For that reason China has become a global player in many economic areas even though per capita figures are still very much lower than those of industrial countries.

German financial transactions with China – an overview

Not only have financial transactions between China and the rest of the world seen dramatic growth; a rapid increase can also be identified in the Sino-German figures in the period from 1990 to 2004 (see Figures 1 and 2). However, most of this increase occurred in the first half of the 1990s, when German financial investment in China rose from just under €230 million (1990) to almost €1.9 billion (1997). German capital exports to China were subsequently curbed by the Asian crisis, which also had a detrimental effect on China indirectly, and by the generally greater reluctance of German investors to go abroad after the burst of the New Economy bubble and the terrorist attacks of 11 September 2001. Nevertheless, since 1990 this investment has amounted to a total of €14 billion, accounting for about 0.5 percent of Germany's aggregate capital exports.



China is attracting more FDI than any other country

* Deutsche Bundesbank. The paper represents the author's personal opinions and does not necessarily reflect the views of the Bundesbank.

¹ The present study is the updated and enlarged version of a paper done as part of the preparatory work for the article in the June 2005 issue of the Bundesbank's *Monthly Report*, "Germany's external relations with the People's Republic of China."

² Although China recorded the largest absolute amount of inward FDI (after Luxembourg) in 2003, in terms of inward FDI as a percentage of GDP it ranks further down the country league table, at just slightly over 35 percent in 2003 (UNCTAD, 2004, p. 13).

³ However, this money partly belongs to mainland Chinese who first take their money out of the country to bring it back in the form of FDI because FDI is privileged vis-à-vis domestic investment (Aykut and Ratha, 2003, pp. 149–176).

Figure 1

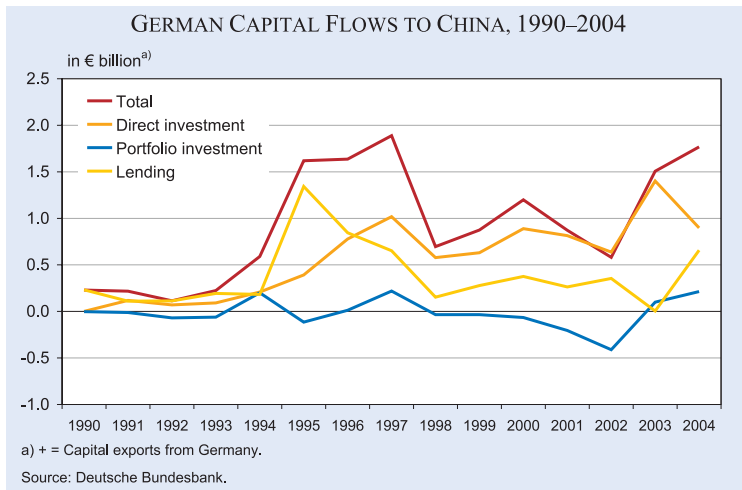


Figure 1 shows the enormous importance which the FDI component of cross-border financial transactions with China has attained during the past few years. Lending to China also played a fairly significant role for a time.

The pattern of Chinese investment in Germany has only a very faint similarity to the picture which emerges on German investment in China (see Figures 1 and 2). It was particularly between 1997 and 2001 and again last year that fairly large amounts of capital flowed from China to Germany. Chinese portfolio investment in Germany was of considerable relevance here⁴, whereas China's interest in direct investment in Germany was negligible.

German direct investment in China

In 2003, China attracted the largest amount of foreign direct investment worldwide for the first time.

At \$54 billion, it pushed the United States, the long-term leader among the host countries for FDI, into second place. This means that in only a few years China has become the most important location for foreign direct investment.⁵

In 2004, German direct investment in China amounted to about €1 billion. Given the sharp reduction in German enterprises' direct investment since 1999, the acquisition of participating interests in China over the past

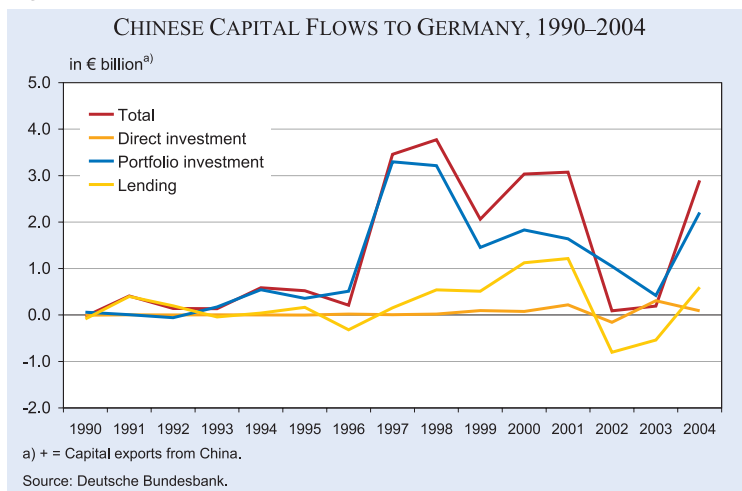
few years has advanced fairly well. It is a reflection of the great expectations which enterprises harbour with respect to China's economic prospects, a sentiment that has certainly also been encouraged by China's accession to the WTO and the associated liberalisation measures taken in many sectors of the economy since late 2001. However, at around 1.5 percent, Germany's share of international direct investment in China in 2004 was fairly small.

China, with a share of just under 1.2 percent at the end of 2003, has also been playing a fairly limited role in terms of Germany's total FDI assets worldwide. By contrast, in terms of the number of people employed by affiliates of German enterprises abroad, China's share at the end of 2003 was 3.6 percent (see Table).

Direct investment in China has been primarily in the form of establishing new enterprises, with most of these being joint ventures with Chinese partners.

While joint ventures were possible as early as one year after

Figure 2



⁴ Only direct inflows are captured in the Chinese capital investments in Germany recorded by the balance of payments. It is possible that, additionally, other funds have flowed into Germany through other international financial centres but cannot be attributed to China statistically.

⁵ Private equity firms have also become increasingly active in China and have been speculating on rising profits for Chinese enterprises seeking a listing on foreign stock exchanges. In the first half of 2004, for example, the rather risky business deals struck by these equity firms generated capital flows amounting to US\$1.2 billion, equivalent to a five-fold increase year on year. The frequent lack of information about the Chinese enterprises' financial position and about their shareholder relationships does not appear to be a deterrent of any importance. (Handelsblatt, 2004-1).

**Stock of German FDI
and employment of German firms abroad
End 2003**

	Foreign direct investment (€ billion)	Employees abroad (thousand)
Total	568.6	4,498
of which Countries in transition	36.1	1,021
of which: China	6.7	160

Source: Deutsche Bundesbank.

China started opening up its economy to the outside world in 1978, foreign companies had to wait until 1987 before they were permitted to establish wholly-owned subsidiaries in China.

Mergers and acquisitions are another form of investment. German firms spent a total of €324 million on completed M&A contracts between 1995 and 2004. By international standards, German firms appear to be quite cautious regarding M&As, given that China recorded inward direct investment amounting to a total of €71.9 billion through M&A transactions during the same period.⁶

A survey conducted by the German Chamber of Industry and Commerce in the spring of 2005 provides an overview of German companies' motives for investing in China. The creation of local production capacity in order to gain a foothold in the market is more important for investment in China than for other German FDI destinations. Cost advantages are also important, although the benefits are much more pronounced in the case of investment in the new EU countries (DIHK 2005).

well as the chemical industry (6.5 percent) and the mechanical engineering industry (6.5 percent) also played an important role.

A significant discrepancy can be observed in the sectoral mix if Germany's direct investment in China is compared with its total outward investment. Just under 60 percent of Germany's investment in China is attributable to the car industry, electrical machinery and apparatus, the chemical industry and mechanical engineering, whereas the share of these sectors in total German outward investment is just under one-quarter. By contrast, direct investment by German financial intermediaries in China has been negligible (2.0 percent). The discrepancy in the relative importance of the various sectors in China and elsewhere for German investors is only partly due to the specific economic conditions in China. What appears to be more important is the fact that investment in China has been subject to considerable legislative and regulatory hurdles and to some extent still is. This is one of the main reasons for the relatively low level of FDI in China's services sector. However, the implications of China's accession to the World Trade Organisation (WTO) on 11 December 2001, especially for the services sector, have been considerable (UNCTAD 2004, p. 55). Among other things, China had to liberalise the services sector, especially banking and financial services, telecommunications, logistics and distribution, transport as well as wholesale and retail trades.⁷ For this reason it

Most German FDI in China has gone to the car industry

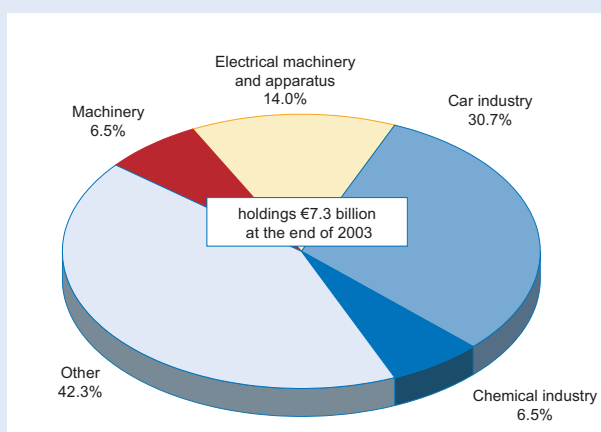
⁷ Since December 2004, it has been possible for insurance companies in China, in which foreigners have stake, to sell not only life insurance but also group policies as well as health insurance (Börsen-Zeitung 2004-1).

Sectoral breakdown of German FDI

German investors' interest in China has been evidenced particularly clearly by the car industry, which accounted for 30.7 percent of all German direct investment in China up to the end of 2003. The manufacturers of electrical machinery and equipment (14.0 percent) as

Figure 3

BREAKDOWN OF GERMAN DIRECT INVESTMENT IN CHINA
by economic sector of investor



Source: Deutsche Bundesbank.

⁶ According to M&A data from Thomson Financial.

is likely that the sectoral breakdown of foreign investment in China will undergo a marked change in the future.⁸

The sectoral breakdown shows a close interrelationship between German direct investment in China and German exports to China. According to Bundesbank data, exports of German machinery and equipment and of German cars, for example, accounted for more than half of all German merchandise exports to China in 2004. What is more, the percentage of German machinery and equipment exported to China was much greater than in Germany's total exports worldwide. Chemical products accounted for 7.4 percent of the deliveries of German goods to China.

German portfolio investment in China has been negligible so far

German portfolio investment in China amounted to €214 million net in 2004 compared with total German portfolio investment abroad of just under €103 billion net. This means that China accounted for no more than 0.2 percent. However, these figures may be an insufficient reflection of China's significance for German portfolio investment as there are foreign quotations of Chinese shares, and, following the official listing of China Life Insurance Company Ltd. with an issue volume of about €3.5 billion in December 2003, a further seven Chinese enterprises were listed on the New York Stock Exchange up to October 2004. The original idea had been to list 40 companies on this US stock exchange during this period (Asia Times Online 2004). The London Stock Exchange and Euronext also announced that they were interested in a second listing of Chinese groups (Financial Times Deutschland 2004-1).

China's stock markets have still not attained any great significance for foreign investors. This is due primarily to the highly restricted investment opportunities for foreigners. Under Chinese law, since February

1992 foreigners can only acquire "B shares" traded in US dollars and Hong Kong dollars directly on the stock exchanges in Shanghai and Shenzhen (China Daily 2002). Sometimes these stocks are not very liquid, with the result that investors have to bear an increased risk. By contrast, the "A shares" quoted in Chinese currency are likely to be of greater interest to foreign investors (emagazine Credit-Suisse 2004). In principle, these cannot be purchased directly by foreign investors, but a group of "qualified foreign institutional investors", as they are called, have had a licence since mid-2003, which allows them to buy limited amounts of A shares. These institutions, in turn, offer products that are based on the A shares. By mid-October 2004, 22 foreign overseas institutions had acquired the right to hold these shares with a value equivalent to about \$2.8 billion (Asia Times Online 2004). There are plans to repeal all restrictions governing foreign investors' activities on the A share market. In the meantime, however, the quota for foreign investors is to be more than doubled (Neue Zürcher Zeitung 2005). It is also planned to merge the A share and B share markets (China & World Economy, 2004). However, the inadequate regulations governing the Chinese stock exchange floors, where foreigners can buy and sell, are another reason why cross-border dealing in Chinese shares has not got properly off the ground. For a long time, the standards on the Chinese stock exchanges were far below those in the industrial countries (and in some emerging markets). It was not until the autumn of last year that stricter requirements, which had long been standard international practice, were added to the framework of rules governing the Chinese exchanges and applied to listed companies.⁹ The fact that more than half of the shares of officially listed Chinese enterprises are not freely tradable and that the enterprises are frequently controlled by the Chinese government does not add to the attractiveness of these firms for foreign investors either (Liu 2005). However, as announced by the China Securities and Regulatory Commission on 24 August 2005, the freely tradable shares of 1300 companies will gradually be increased by \$270 billion (Bloomberg 2005).

However, amendments to the laws and regulations governing the activities of Chinese companies abroad are also in preparation. A "Qualified domestic institutional investors" scheme similar to the

⁸ A shift in the sectoral mix of German investment in China is already taking place. Deutsche Bank, for example, was allowed in the final quarter of 2004 to buy and sell shares on the stock exchange in Shanghai and Shenzhen, an activity which had hitherto been exclusively in Chinese hands. Furthermore, in October 2002 Allianz, the insurer, was the first international enterprise, along with its Chinese partner, to receive a licence for fund management (WirtschaftsWoche 2004). However, investing in the highly regulated Chinese insurance market has not yet proven to be a goldmine for foreign investors. No international insurer has acquired through its joint venture a market share of more than 0.2 percent in China, and profitability seems to be the exception rather than the rule (Börsen-Zeitung 2004-1). In addition, Deutsche Post sees great potential in China and wants to quadruple the number of branches (Frankfurter Allgemeine Zeitung 2004).

⁹ "There is a saying in China: If you want to have a punt in this traditionally gambling-crazy country, you have two options – either head for Macao, the former Portuguese colony that is the only place on the mainland where gambling is legal, or invest in the stock market" (Asia Times Online 2004).

The composition of German FDI in China closely resembles that of its exports to China

“Qualified foreign institutional investors” scheme is also planned. However, its implementation has been repeatedly delayed as there have been fears that liquidity would be withdrawn from the Chinese market and that prices on the country's capital markets would come under further pressure. Then in an initial move in the middle of September 2004, the Chinese government announced it was prepared to allow Chinese insurance companies to invest abroad (Asia Times Online 2004). This measure is also seen as a means of promoting the convertibility of the Chinese currency (China Daily 2004).

There have also been rapid developments on the Chinese bond markets since the policy of opening up the Chinese economy to the outside world was set in motion in the late 1970s. However, the spread of corporate bonds has remained far behind that of government paper, and the promotion of corporate bonds was included in the tenth five-year plan (2001-05). As expected, the role played by bonds is not yet as great in China as it is in industrial countries. The value of bonds in China reached about 29 percent of GDP in 2002 whereas the corresponding ratio for the United States was 143 percent and for the European Union no less than 82 percent. The market for financial derivatives is also underdeveloped in China (China Daily 2003).

The People's Republic of China, in a bid to increase the attractiveness of its government bonds for European investors, announced on 12 October 2004 the issue of a ten-year euro bond with a volume of more than €1 billion, its largest euro-denominated issue to date (Börsen-Zeitung 2004-2). In order to meet the increasing need for information on the Chinese bond markets, Lehman and Xinhua established the Xinhua Lehman Bond Index last year. The index captures 136 fixed-interest securities with a market value of CNY 1.8 trillion (equivalent to about €170 billion) and was backdated to 1 January 2004 (Die Welt 2004).

These developments show that a great deal is happening in China's securities markets, too. In the longer term, this could also have positive implications for China's cross-border portfolio investment.

Future developments

China's economic attractiveness is due to several factors. Low labour costs are the first of these.

Though they have already started to rise on the coast in particular, in the medium term they will presumably remain far below the level prevailing in industrial countries, with the result that China's importance as a manufacturing location for labour-intensive products will continue to be substantial. At the same time, Chinese firms now appear to be gaining a foothold in the high-tech sector.¹⁰ China's role as an export market will also become more important in future¹¹, and its position among the world's most important economies will be strengthened. Owing to its large population, even modest increases in per capita income would result in more significant changes in the purchasing power of the entire country than they would in other economies. The International Monetary Fund estimates that China can expect an 8.5 percent GDP growth this year and 8.0 percent next year. The conditions that China has already met in connection with its accession to the WTO and the further improvement in its underlying framework, once the remaining reforms have been completed, could provide additional stimuli to economic growth.

Further advances in China's economic role, especially for Germany, can be expected not only in absolute terms but, increasingly, also relative to the other foreign locations for German FDI, the reason being that not even 10 percent of direct investment in China since 1997 has originated in Europe, Germany being Europe's leading investor (IW 2004).

Despite all the optimism about China's future growth, however, the risks which investing in China entail and which have become more apparent recently should not be overlooked. Thus, a growing equity bubble in China is giving cause for concern. The Chinese government is taking restrictive measures in an attempt to prevent the economy from overheating.¹² The measures taken so far to curb output are already resulting in reductions in demand in some sectors. Particularly the restrictions in lending to households in conjunction with increasing traffic problems, especially in the conurbations, have led to

German portfolio investment in China may be understated

¹⁰ At all events, this is the opinion of Heinrich von Pierer, chairman of the supervisory board of Siemens AG (Asian-Pacific Committee of German Business 2004).

¹¹ Bernd Pischetsrieder, chairman of the board of directors of Volkswagen AG, is also convinced of the great potential of the Chinese market: “In zehn Jahren wird china wohl der größte Markt der Welt sein [in ten years China will likely be the largest market in the world]”. (Financial Times Deutschland 2004).

¹² The Chinese authorities are walking a tightrope. They are trying, on the one hand, to prevent the economy from overheating and, on the other, to avoid a hard landing, and this set of circumstances could be fraught with social and political tension owing to the large number of additional labour coming on to the labour market (Neue Zürcher Zeitung 2004-1).

a significant decrease in car manufacturers' sales on the Chinese market. The German car industry has also been affected by this slump in demand. However, in other sectors, too, notably mobile telephones and real estate, there appears to be overcapacity (Handelsblatt, 2004-2).

Electricity supply is fraught with additional imponderables, and environmental pollution is gradually becoming a topic of discussion. Generally speaking, improvements in the infrastructure, which have to keep pace with the rapid rate of economic growth, pose an enormous challenge for the Chinese government. The institutional framework is also unsatisfactory in some respects, notably the legal uncertainties that still exist in certain areas and the lack of market transparency. Although legally acquired private property has enjoyed protection since the constitutional reform in the spring of 2003, judiciary independence is not yet fully guaranteed. The lower courts are still materially dependent on local governments (Neue Zürcher Zeitung 2004-2).

Summary

China has boasted high growth rates, and its future economic potential appears considerable. In view of the Chinese government's policy of opening the country up to the outside world, many promising opportunities have been emerging for foreign investors despite all the remaining imponderables. With regard to Germany's financial transactions with China, the country will assume greater importance, especially as a destination for German foreign direct investment. Although German FDI in China has already grown considerably, notably in the 1990s, its importance relative to FDI flows to other countries is still comparatively low. Loans, primarily trade credits, also play a fairly important role from Germany's point of view. Conversely, Chinese investor interest has so far concentrated on German bonds, although lending, too, has led to net capital inflows from China over the past few years. Considerable reform is still needed in portfolio investment, mainly because, after decades of a socially planned economy, the capital markets are still underdeveloped and the Chinese currency is not yet convertible, although on 21 July 2005 the peg of the currency was switched from the US dollar to a basket consisting primarily of the US dollar, the euro, the yen and the Korean won as well as several other currencies.

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Despite high GDP growth in China, the risks of investing there are high