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German-Chinese Economic Relations—Opportunities and Risks

by Georg Erber

Economic relations between Germany and China have developed exceptionally well over the past few decades. China has grown to become one of Germany's key trading partners and may even become the second-largest trading partner after France in the coming year. And yet China's focus is increasingly shifting towards capital goods manufacturing, meaning Chinese enterprises will be competing with German enterprises more strongly on global markets. There are more and more indications that the extensive direct and indirect subsidizing of businesses in China is a major contributory factor to cutthroat competition, which is becoming increasingly incompatible with the concept of free trading within the WTO regulatory framework. Recent examples of this can be found, in particular, in the manufacture of wind turbines, photovoltaic installations, and, more recently, even high-speed trains, as well as the exploitation of China's quasi-monopoly on rare earths. In other high-tech sectors, too, the competition is likely to become fiercer. What is needed, therefore, is forward-looking industrial, innovation and trade policy that does not create major distortions of competition in Germany's economic relations with China.

As a result of the economic reforms introduced by Deng Xiaoping in the late 1970s, the Chinese economy has developed into a socialist market economy with very specific features and has experienced rapid catch-up growth in comparison with western industrialized countries. In 1994, China's real GDP was on a par with that of Germany, and by 2001 it had reached the same level as that of Japan. By 2016, it is expected to catch up with the USA¹ (Figure 1). China's entry to the World Trade Organization (WTO) in 2001 enabled it to surge ahead in global trade, thanks to export-oriented growth and major technological transfer from abroad, facilitated by low labor costs and an attractive exchange rate.

China's economic growth has proved to be steadfast, particularly during the 1998 Asian crisis and the global recession in 2008/2009. This is down to various measures taken to get the economy moving again.² Recently, China has been one of the biggest drivers of global economic growth, a development which is expected to continue in the year ahead, provided, of course, the debt crisis within the eurozone does not worsen (Figure 2).

Track Record in Economic Cooperation ...

As a major export nation, especially in the automotive sector and mechanical engineering, Germany has profited from the fast growing domestic market in China. In turn, China has become an important export market and supplier for Germany, in particular in the ICT

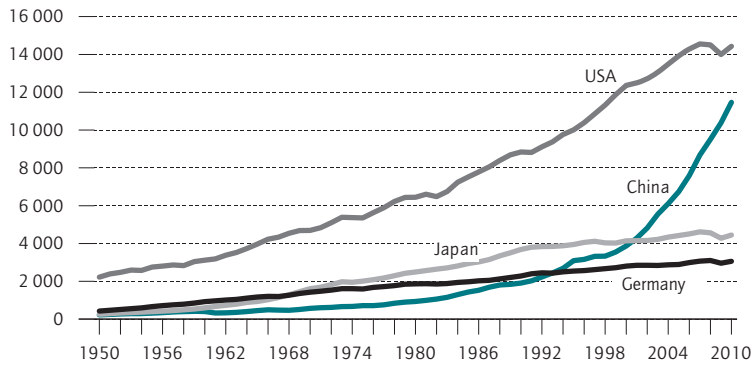
¹ Calculated in EKS purchasing power parities, price basis 2010. EKS = Multilateral Fisher Index as per Eltoto, Kovacs and Szulc. See also Conference Board, Productivity, Employment, and Growth in the World's Economies, Total Economy Database™, update, New York, September, 2011; S. Jingli, "China's economy to surpass US in 2016: IMF," China Daily, April 26, 2011.

² C. Dreger and Y. Zhang, "The Chinese Impact on GDP Growth and Inflation in the Industrial Countries," DIW Discussion Paper no. 1151 (2011).

Figure 1

Growth of Real GDP¹

In US dollars (bn)



¹ Price basis 2010, all figures converted using EKS purchasing power parities from 2005.
Source: Conference Board, Total Economy Database.

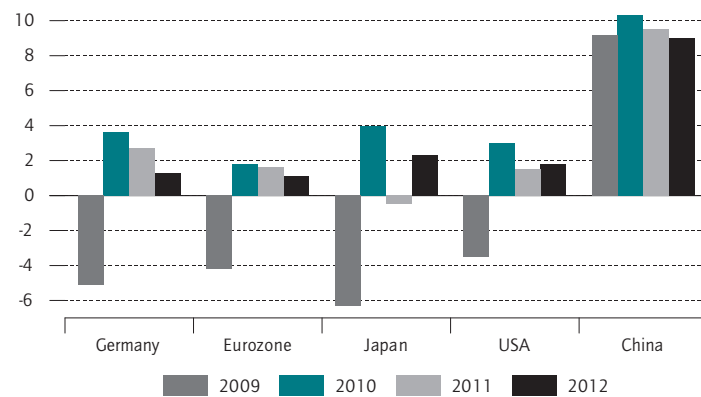
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WTO membership speeds up China's rapid catch-up growth even more.

Figure 2

Real GDP Rates of Change

In percent



Source: IMF, WEO September 2011.

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China's economic growth proved to be stable despite the 2009 financial crisis.

sector. In the first half of 2011, this resulted in a trade deficit of 6.1 billion euros for Germany.³

Owing to the increase in the global division of labor, China has become exceedingly important in the glo-

³ Destatis, "Foreign trade for first half of 2011: exports increased by 14.7 per cent," press release no. 340 of September 15, 2011.

bal value chain in its capacity as a production location for German businesses. This year, China is expected to become Germany's fourth-largest trading partner after France, the USA and the Netherlands.⁴ In the coming year, China may even become the second-largest trading partner after France. In the first half of 2011, exports to China went up by 25.2 percent in comparison with the first half of 2010, while German exports grew by a total of 14.7 percent. Germany's trade with other countries in the EU27 increased by just 13.4 percent (Figure 3).

As an export nation, Germany has managed better than other European countries to participate in China's integration into the global economy. Industrialized countries that were hit particularly hard by the global financial and economic crisis, in contrast, have had to face declines in growth, as they were not quite as successful in shifting their focus to these markets.

China has also become the most important growth market for Europe's total exports.⁵ In 2010, goods and services exported from EU27 countries to China totaled 113.1 billion euros. Despite this, the trade deficit between the EU and China went up to 168.6 billion euros last year. Thanks to Germany's increasingly important role, especially with regard to exports to China, this lopsided development in foreign trade with China is not quite as apparent.

Europe exports mainly machinery and vehicles (approx. 60 percent of all exports in 2010), as well as chemicals and raw materials. The main imports from China, in contrast, are textiles and ICT products. In the latter sector, China has already overtaken the USA to become the leading supplier of ICT goods.⁶

China is striving hard to catch up with the leading manufacturers of hi-tech products. Parallel to this, the development and expansion of infrastructure in the country has resulted in showcase projects which will form the basis of future export strategies. In particular, the development of a high-speed rail network has swallowed up more than 300 billion US dollars in the past four to

⁴ M. Kaelble, "China steigt zum viertgrößten Exportmarkt auf," Financial Times Deutschland, November 11, 2011.

⁵ Eurostat: "EU/China Summit / Strong increase in EU27 exports to China in the first half of 2010 / China now the second-largest trading partner of EU27," STAT/10/1475.

⁶ In 2008, China already had a balance of trade surplus for ICT products totaling 125,240 billion US dollars for a total volume of trade of 735,707 billion US dollars. The USA, in contrast, had a balance of trade deficit of 112,933 billion US dollars for a total volume of trade of 460,832 billion US dollars. See OECD: OECD Information Technology Outlook. Paris: OECD, 2010.

five years.⁷ This industrial policy brings about an ever increasing need for raw materials. Furthermore, Germany and China, and even Japan, could be put under increasing pressure from deficit countries around the world, especially the USA, to reduce their surpluses to a greater extent (Figure 4).

... Yet Growing Risk from Tension in Economic Relations

With the development and expansion of its own capital goods industry, China can be expected to pose stronger competition for German industry in the future. China is putting huge efforts into the development of a domestic innovation system that will help it take on a leading international role in this field by 2020.⁸

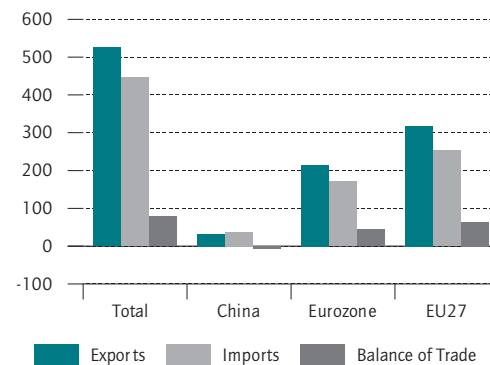
Finally, with the help of affordable exports, China has managed to increase its global market share hugely, especially in the area of photovoltaics (PV), with Germany's global market share for PV products having fallen from 69 to 21 per cent since 2004. In the same period, China's share increased from 7 to 45 percent.⁹ This has led to trade tensions with China over the significant turnover losses that German PV manufacturers have suffered as a result. The company SolarWorld, for example, filed an official complaint with the WTO about China's dumping practices.¹⁰

On the other hand, trade barriers hinder the export of wind power units to China, with government contractors giving local manufacturers such as Sinovel or Xinjiang Goldwind Science and Technology priority when

Figure 3

Germany's Foreign Trade with China, the Eurozone, and EU27 in the First Half of 2011

In euros (bn)

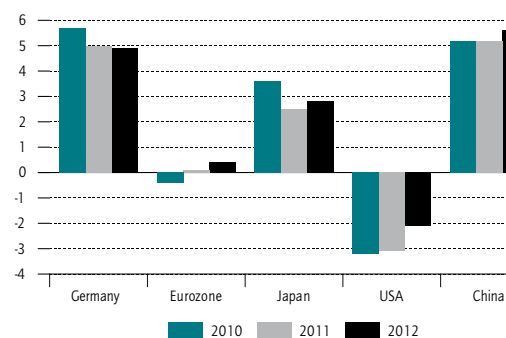


Source: destatis, calculations by DIW Berlin.

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Figure 4

Balance Net Totals in Proportion to GDP in percent



Source: IMF, WEO September 2011.

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⁷ High-speed trains have been running for four years now across a total of 8,400 km of railroad. The last high-speed rail link to be opened was Beijing-Shanghai. This is to be expanded to approx. twice its distance. Unfortunately, developments in this area are not entirely problem-free. See X. Yang, "Störfall im Harmonie-Express," Spiegel Online, July 21, 2011. This led to the need for substantial additional investments. See X. Dingding and W. Yong, "\$31 b govt stimulus to revive railway projects," China Daily, November 2, 2011. China is, however, planning to continue exporting this technology worldwide, thus constituting direct competition to German ICE high-speed trains.

⁸ H. Hagemann, J.P. Christ, R. Rukwid, and G. Erber, Die Bedeutung von Innovationsclustern, sektoralen und regionalen Innovationssystemen zur Stärkung der globalen Wettbewerbsfähigkeit der baden-württembergischen Wirtschaft. Hohenheim: 2011; G. Erber and H. Hagemann, "Die Rolle staatlicher Institutionen in asiatischen Innovationssystemen," Vierteljahrshefte zur Wirtschaftsforschung 77 (2) (2008): 95-112.

⁹ F. Groba and C. Kemfert, "Erneuerbare Energien: Deutschland baut Technologie-Exporte aus," DIW Wochenbericht no. 45 (2011).

¹⁰ At the same time, the International Trade Commission of the US Congress sustained a complaint filed by SolarWorld on December 2, 2011, ruling that punitive duties and anti-dumping sanctions be imposed on both parties; "China Rejects U.S. Trade Ruling That Solar Imports Harm Industry," Bloomberg News, December 4, 2011.

allocating contracts.¹¹ Owing to the massive subsidizing of wind power technology in China, the UN has already stopped subsidies from industrialized nations via the Clean Development Fund. What is more, accusations of industrial espionage have been made towards Chinese enterprises such as the wind turbine manufacturer Si-

¹¹ J. Niewöhner, "Repower zieht sich aus chinesischem Windmarkt zurück," Green Financials, October 25, 2011.

novel.¹² Finally, tensions have increased over China's price and export policy for rare earths, where China currently has a quasi-monopoly.¹³

In connection with this, co-operation between government, businesses, banks and the state-owned Assets Supervision and Administration Commission (SASAC) is crucial, the main aim being to gain competitive advantages on the global markets through targeted industries and technologies, as well as to protect the domestic market.¹⁴

Instrumental in this is offsetting losses in expansive market penetration strategies pursued by Chinese state-owned enterprises (SOEs), a process that involves the state-controlled banking system.¹⁵ Around half the value added (VA) of the Chinese economy outwith the agricultural sector is state-controlled, either directly or indirectly. Additionally, the government often forces foreign firms into joint ventures with public enterprises or state-controlled businesses in China.

The other half of China's VA comprises private enterprises which are financed largely by a shadow banking system, since access to state financial institutes is very difficult.¹⁶

Most of Germany's direct investments in Asia are made in China...

German businesses have increased direct investments in China hugely since China opened up its markets to foreign investment, almost reaching the 25 billion euro mark in 2009 (incl. Hong Kong). Activities in Japan, in contrast, are far lower at just 8.4 billion euros (Figure 5).

¹² K. Hille, G. Dyer, and F. Harvey, "UN halts funds to China wind farms," *Financial Times*, December 1, 2009; K. Werner, "Industriespionage wirbelt Windindustrie durcheinander," *Financial Times Deutschland*, September 22, 2011.

¹³ H.G. Hilpert and A.E. Kröger, "Chinesisches Monopol bei Seltenen Erden: Risiko für die Hochtechnologie," *DIW Wochenbericht* no. 19 (2011).

¹⁴ In the latest 5-year plan which was passed by the National People's Congress in March 2011, seven strategic emerging industries (Clean Energy Technology, Next-Generation IT, Biotechnology, High-End Equipment Manufacturing, Alternative Energy, New Materials, Clean Energy Vehicles) are named. See J. Casey and K. Koleski, (2011): Background: China's 12th Five-Year Plan, U.S.-China Trade and Security Review Commission, One Hundred Twelfth Congress, Washington D.C.: June 24, 2011.

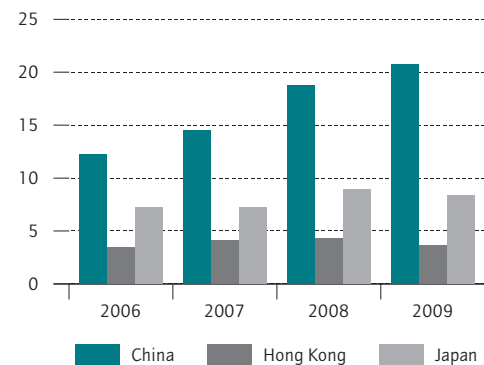
¹⁵ G. Ferri and L.-G. Liu, "Honor Thy Creditors Before Thy Shareholders: Are the Profits of Chinese State-Owned Enterprises Real?" HKIMR Working Paper no. 16/2009, Hong Kong: Hong Kong Institute for Monetary Research, 2009.

¹⁶ A. Szamosszegi and C. Cole Kyle, *An Analysis of State-owned Enterprises and State Capitalism in China*, Washington D.C.: U.S.-China Economic and Security Review Commission, October 26, 2011.

Figure 5

Germany's Direct Investments¹ (Assets) in China, Hong Kong, and Japan

In euros (bn)



¹ Direct investments not incl. indirect investments via dependent holding companies.

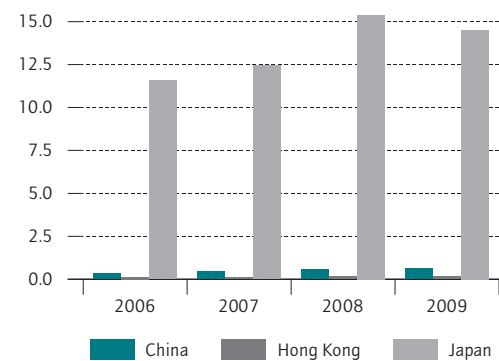
Source: Deutsche Bundesbank.

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Figure 6

Direct Investments¹ (Assets) by China, Hong Kong, and Japan in Germany

In euros (bn)



¹ Direct investments not incl. indirect investments via dependent holding companies.

Source: Deutsche Bundesbank.

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re 5).¹⁷ Up until now, the increase in direct investments was complementary to the expansion of exports: even the relocation of many production sites from Germany to China did not cause export figures to drop.

¹⁷ Deutsche Bundesbank: "Bestandserhebung über Direktinvestitionen," Statistische Sonderveröffentlichung 10, Frankfurt am Main, April 2011.

... Yet China's Direct Investments in Germany Have Remained Minimal to Date

Unlike the increase in German direct investments in China, China's direct investments in Germany have been very poor so far, totaling as little as 0.8 billion euros in 2009 (Figure 6). This may change in the future, however, as China, in the course of industrialization, continues to develop its own marketing and sales, as well as repair and maintenance networks on foreign markets. In the ICT sector, in particular, Chinese firms such as Lenovo, Huawei or HTC are increasingly moving towards direct product sales in Germany. The creation of brands with global recognition calls for the establishment of offices in Germany and in the eurozone. So far, Germany has not been a particularly attractive production location for Chinese businesses. The need for technologies which have not been part of the Chinese portfolio up until now, however, will mean that the takeover of SMEs will become increasingly important, although this could also result in problems relating to competition law. The establishment of a joint venture between the state chemicals corporation Sinochem and the Dutch company DSM, for instance, was scrutinized by the EU competition authorities.¹⁸ The joint venture was approved in the end; however, this is a prime example of the legal and regulatory obstacles in the path of future takeovers and mergers between Chinese and European companies.

Conclusion

For economic cooperation to continue to be successful, suitable specialization patterns for intra-industrial trade which profit both sides are needed. This must not, however, result in cut-throat competition in the key business fields, as seen in the areas PV, wind power or high-speed trains. Partnerships in those areas where no direct competition exists would also be of interest. Especially the latent trade conflict between the USA and China ought to be a cautionary example of the fact that sustainable economic cooperation requires a fair balance between the economic partners and must be equally beneficial to both sides. This includes, in particular, a relatively even trade balance in order to rule out the risk of balance of payments crises. Furthermore, technological transfer based on the preservation of intellectual property rights must be as non-discriminatory as possible in both directions.

China's status as a developing country, as set down in international aid programs, has to be re-assessed. China has sufficient means to finance its high-tech development strategy independently. Furthermore, to ensure tension-free trade, it is important that the very nature of Chinese strategic industrial policy does not result in severe competitive distortions.

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¹⁸ "Of Emperors and Kings-State Capitalism in China," *The Economist* November 12, 2011.

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