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Article

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DIW Economic Bulletin

Provided in Cooperation with:
German Institute for Economic Research (DIW Berlin)

Suggested Citation: Erber, Georg (2014) : German-Chinese economic relations: Opportunities and risks for Germany, DIW Economic Bulletin, ISSN 2192-7219, Deutsches Institut für Wirtschaftsforschung (DIW), Berlin, Vol. 4, Iss. 2, pp. 8-13

This Version is available at:
https://hdl.handle.net/10419/92930

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German-Chinese Economic Relations—Opportunities and Risks for Germany

by Georg Erber

During the last few years, the People's Republic of China has become an increasingly important trading partner for Germany. Particularly in the wake of the global economic and financial crisis that began in 2008, trade with China has been an important driver of economic growth in Germany as German industry benefited from the increase in Chinese import demand more than other European countries. However, Chinese economic growth has slowed somewhat since then. After recording double-digit growth rates in the past, the new Chinese government is now attempting to stabilize annual economic growth at 7.5 percent. It is therefore likely that future German export growth rates to China will be lower than in recent years. Further, according to the government's new plans, Chinese economic growth should rely less on export and investment, as has been the case to date, and more on domestic performance and private consumption in the future. It is anticipated that this shift will also have a negative impact on German export industry, which is dominated by capital goods. Additionally, Chinese demand for imports is likely to decline as China's domestic production of cars and machinery expands.

The inauguration of the new Chinese leadership in spring 2013 represented more than just a change in government—under the new regime, a shift in the direction of Chinese economic policy has also been evident. Responding to its foreign trade partners, China is set to reduce its substantial current account surplus to redress the structural imbalances in the world economy.[1]

Germany finds itself under similar pressure since, after China, it is among those countries recording high current account surpluses in the global trade in goods year after year.[2] However, Germany has reported a moderate trade deficit with China to date, i.e., Germany imports more than it exports.[3]

In the first half of 2013, the total value of German companies' exports to China was approximately 32.3 billion euros. Compared with the same period in 2012, this represented a decline of almost six percent. Thus, it seems that there is already evidence of a post-boom slowdown in German-Chinese trade. However, recent figures point towards a slight upturn. In July 2013, for example, exports totaled 6.1 billion euros, which represented a three-percent increase compared with July 2012. Nevertheless, exports for 2013, up to and including July, remained 4.6 percent below the figure for the same period of 2012.

German imports from China also followed a downward trend in 2013: in the first half of 2013, they totaled 35.4 billion euros, which was 5.6 percent lower than the corresponding figure for the previous year. Here too, July 2013 saw significantly better results, with Chinese exports to Germany declining by only 1.9 percent, in com-

1 W. Pettis, The Great Rebalancing: Trade, Conflict, and the Perilous Road Ahead for the World Economy (Princeton, NJ: Princeton University Press, 2013).

2 "Deutschland vor größtem Überschuss aller Zeiten," Die Welt, September 5, 2013.

3 G. Erber, "Economic Relations between China and the EU, the Euro Area and Germany," SSRN Paper (July 2013).

parison with July 2012, to just over 6.5 billion euros.[4] Nonetheless, in the first seven months of 2013, Chinese exports to Germany were still five percent below the corresponding figure for the previous year.

China's Fragile Financial System

Based on developments to date, a slowdown in China's economic growth should be expected (see Figure 1). However, a major slump is unlikely despite initial fears generated by a series of liquidity bottlenecks in the Chinese Internet banking market.[5] As a result of the Chinese central bank implementing measures to curb credit growth and suppress the shadow banking system, June 2013 saw a surge in Chinese interbank interest rates.[6] However, the central bank immediately relaxed the measures to steady the markets again. Yet the situation was an early warning signal for the vulnerability of the Chinese financial system which had also experienced unprecedented levels of excess liquidity as a consequence of the global economic and financial crisis, much the same as Western countries.[7] The result was a substantial increase in the fragility of China's financial system.

In 2009, not only did the People's Republic issue the largest economic stimulus package (based on GDP),[8] but also relaxed credit conditions considerably.[9] This resulted in significant growth of the Chinese shadow banking system, which, according to expert estimates, is now worth approximately 5.8 trillion US dollars,[10] a figure equivalent to around 64 percent of China's GDP.

Officially, massive capital controls are in place; however, they can be circumvented using a variety of methods, such as transfer pricing[11] and fake invoices,[12] in particular, which enable easy movement of capital across China's borders. Hong Kong serves as a key hub in this process.[13] Thus, like countries with convertible currencies and free movement of capital, to a great extent, China also faces the monetary-policy "trilemma";[14] in these circumstances, exchange rate and price stability cannot be regulated simultaneously. The real effective Chinese currency exchange rate has already been on the increase for some time (see Figure 2). What remains unclear is whether this is a deliberate political choice or the result of extremely ineffective capital controls. The latter could also be a motive for the Chinese government to make the renminbi convertible.[15]

Corruption in China Also Affects Foreign Trade

One of the key objectives of the new Chinese leadership is to combat the country's excessive corruption, which the previous government had already recognized as a major threat to the stability of Chinese society.[16] A series of high-profile trials of leading government and Communist Party representatives signaled the first steps in the fight against corruption. The trial of the former minister of railroads for large-scale bribery and abuse of power while in office, which resulted in a suspended death sentence, is clear evidence of how corruption has spread right up to the top echelons of the party and the government.[17] As the Chinese economy has flourished, corruption has taken on ever greater proportions.

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4 Destatis, Außenhandel – Zusammenfassende Übersichten für den Außenhandel (Wiesbaden: Federal Statistical Office, July 2013).

5 "Markets Precipitate Tightening," BIS Quarterly Review (September 1-11, 2013).

6 G. Ma and C. Shu, "Interbank Volatility in China," BIS Quarterly Review (September 10, 2013).

7 Carl E. Walter and F. J. T. Howie, Red Capitalism—The Fragile Financial Foundation of China's Extraordinary Rise (Singapore: Wiley & Sons, 2012).

8 In 2009, China increased its national deficit by 16 percent of its GDP to support the economy, far exceeding all other countries' efforts. Stimulus packages implemented in the US (14 percent of GDP) and Germany (seven percent of GDP) were substantially smaller. IMF, Fiscal Monitor – Fiscal Adjustment in an Uncertain World, (Washington D.C.: International Monetary Fund, April 2013).

9 "...in 2009 and 2010 things went too far. Spurred on by the government, China's banks increased their lending by almost 9.6 trillion yuan ($1.5 trillion) in 2009. That is roughly twice the size of the Indian banking system, as Bank Credit Analyst, a research company, has pointed out. In other words, China's lenders added two Indias to their loanbook in the space of a year." Simon Cox, "China. Keynes vs. Hayek in China," The Economist, November 17, 2011.

10 D. Roberts, "China's Shadow Banking Sector Tops $5.8 Trillion, Report Says," Businessweek, May 8, 2013.

11 This entails a system of transfer prices which are significantly too high or too low compared with the actual value of goods, with the aim of transferring profits or losses abroad. See also PriceWaterhouseCoopers, Standing out from competition—Transfer Pricing in China, (Shenzen: 2013).

12 "China Confiscates 70 Million Fake Invoices," Xinhua, July 13, 2011.

13 R. Fisman and E. Migual, Economic Gangsters: Corruption, Violence, and the Poverty of Nations (Princeton: Princeton University Press, 2008).

14 The Impossible Trinity model was developed both by John Marcus Fleming in 1962 and Robert Alexander Mundell in 1963, independently from one another. In simplified terms, the model can be described as a triangle whose corners represent the three exchange rate policy objectives: stable exchange rate, sovereign monetary policy, and free capital flow. In the trilemma, a maximum of two of these objectives can be achieved at the same time. According to the model, it is impossible to achieve all three simultaneously.

15 G. Erber, China: Country of Endless Opportunities?, 20 December 2013, SSRN-paper.

16 Reuters, "China's Hu Says Graft Threatens State, Party Must Stay in Charge," November 8, 2012; T. Yanqi and L. Shaohua, Bloomberg, "Wen Pledges to Curb Graft, Income Inequality as Police Head Off Protests," February 28, 2011.

17 "Chinesischer Ex-Minister zu Todesstrafe auf Bewährung verurteilt," Süddeutsche Zeitung, July 8, 2013.

Evidently, foreign companies are also implicated in this corruption to a great extent.[18] US and UK pharmaceutical companies in particular have come under massive pressure for bribing doctors and hospitals.[19] As a result of such illegal business practices by foreign drug companies, prices charged in China for pharmaceuticals are significantly inflated compared to the US and Europe. Thus, China's fight against corruption and bribery has acquired a dimension that also impacts foreign trade.

Trade Sanctions Lead to Tensions

The conflict over "dumping prices" and illegal subsidies for Chinese photovoltaic panels led to international disputes with the Chinese government. After a number of solar panel manufacturers in the US and the European Union (EU) were no longer able to withstand the price pressure of cheap imports from China, the US imposed anti-dumping import duties.[20] The European Commission, on the other hand, was able to negotiate a provisional agreement with China, determining the volume and prices of Chinese imports to the EU[21] and averting an escalation in the trade dispute with China for the time being. Since Germany is China's most important trade partner in the EU,[22] German manufacturers in particular would have suffered from the consequences of such a development. However, this conflict is far from being the only problem in foreign trade with China requiring a solution: by 2017 at the latest, the People's Republic would like to be recognized as a market economy under World Trade Organization (WTO) rules. If this were to happen, the range of possible sanctions that could be imposed on Chinese imports, should they be at an advantage due to unfair competitive conditions, would no longer be available.[23] Since China's state-owned enterprises and banks are so tightly interlocked and their business policies are subject to political influence, it is likely to become more difficult to provide evidence of unfair trading practices in individual cases in the future.[24] Even if misguided subsidies were to cause the Chinese economy long-term damage,[25] foreign competitors would still remain at a disadvantage.

Figure 1

Quarterly Real Growth in China's GDP

In percent, compared with same quarter of previous year

Source: Bureau of Statistics of China.

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China's growth recovered quickly after the global financial and economic crisis, but recently tailed off again.

German Automobile Manufacturers Enter Chinese Market

An important goal of the new Chinese government's economic policy is the further expansion of a domestic automotive sector. This goes beyond the domestic Chinese market: the People's Republic is seeking to become a global export leader also in the auto industry by 2016 with at least one producer among the ten largest in the world by then. The Shanghai Automotive Industry Corporation (SAIC) aims to increase exports by over 130 percent every year from now on and sell roughly 800,000

18 "According to Beijing-based private research firm Anbound Group, of some 500,000 corruption cases investigated in China from 2000 to 2009, about 64 percent were linked to international trade and foreign businesses." C. Weihua, "Multinationals Under Scrutiny for Corruption," China Daily, September 8, 2010. "Why Corruption is Inevitable in China's Pharmaceutical Industry," China Briefing, July 25, 2013.

19 "The allegations follow a series of corruption claims in the pharmaceuticals business and probes opened by the authorities against Novartis, Sanofi, Lundbeck and AstraZeneca. GlaxoSmithKline has been accused of handing over illegal payments totaling up to $500m." A. Jack and P. Waldmeir, "Eli Lilly Drawn into Pharmaceutical Corruption Claims in China," Financial Times, August 22, 2013.

20 "Timeline: China-EU, China-US Tug of War on Solar Duties," People's Daily, June 17, 2013.

21 "We found an amicable solution in the EU-China solar panels case that will lead to a new market equilibrium at sustainable prices." Commissioner De Gucht, press release, July 27, 2013 (European Commission, 2013).

22 G. Erber, "German-Chinese Economic Relations—Opportunities and Risks," DIW Economic Bulletin, no. 50 (2011): 3–7.

23 U. C. V. Haley, Subsidies to Chinese Industry: State Capitalism, Business Strategy, and Trade Policy (Oxford University Press, 2013).

24 "In contrast, China's state-owned firms typically enjoy preferential treatment in terms of administrative approval and bank loans. Although most firms report profits, totaling US$ 920 billion from 2001 to 2009, the state is saddled with a negative 1.47 per cent real average return on equity after accounting for US$1.19 trillion of subsidy and foregone costs." Z. Yajing and W. Jun Jie, "China Has Need of Well-Run State-Owned Enterprises," South China Morning Post, August 28, 2013.

25 Dexter Roberts, "China Profit Rise Masks State Enterprise Weakness," Businessweek, June 27, 2013.

vehicles abroad in 2015. The Dongfeng Motor Corporation also has high growth targets: a 50-percent increase every year through 2016, to approximately 300,000 vehicles. The most important markets for these companies are in Asia, but China also plans to establish itself as a powerful competitor in Europe.[26]

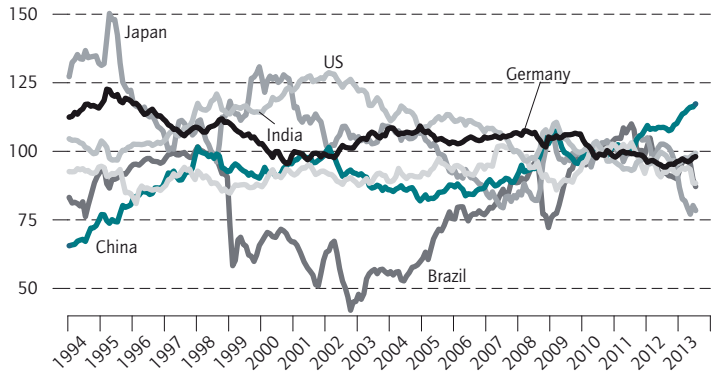
German automobile manufacturers in particular have been successful in China in recent years—primarily in joint ventures: for example, Volkswagen (VW) has been cooperating for years with SAIC, currently the largest Chinese group manufacturing cars, motorcycles, and car parts, as well as with First Automotive Group (FAW), the top Chinese manufacturer of diesel engines, cars, and medium to heavy buses and trucks. Thus, Germany's largest auto manufacturer has close ties to two Chinese state-owned companies. To underline the close cooperation with the Chinese government, VW's chief executive was the only German representative and the only automobile executive to be appointed to a central advisory body of the Chinese prime minister.[27]

After General Motors (GM), VW is one of the largest foreign automobile manufacturers on the Chinese market.

However, BMW and Daimler-Benz are also increasing their production capacity in China. BMW is cooperating with the Chinese manufacturer Brilliance China Auto (BMC) and producing some cars for the Asian market directly in China. Daimler-Benz is also producing trucks in a joint venture with Beijing Automotive Industry Holding (BAIC), the fifth-largest Chinese manufacturer, and is planning to produce cars in the same manner in the near future.[28] The ten-percent stake of the China Investment Cooperation (CIC) in Daimler-Benz, which had originally been envisaged, seems to have been abandoned for the time being.[29] However, all these activities demonstrate that German manufacturers in particular are involved in advancing the massive expansion of capacity in the Chinese automotive sector.

Figure 2

Real Effective Exchange Rates
Index 2010 = 100



Source: Bank for International Settlements (BIS).

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China's currency exchange rate has been increasing strongly for some time.

From the perspective of the individual companies, this may be the right strategy, but in the medium to long term, it is likely to have an impact on German automobile exports to China: from the Chinese point of view, it can be assumed that automobile imports from Germany will generally be substituted by means of production facilities in China. The example of Daimler-Benz shows that this refers not only to final assembly of vehicles. One of the facilities in the world's largest auto industry park near Beijing is a Daimler engine plant, and in the future there will also be a painting plant.[30]

According to the German Association of the Automotive Industry (VDA), roughly 20 percent of the cars currently sold in China carry a German corporate brand. Since 2005, German auto manufacturers have increased their sales in China sevenfold. Recent figures provided by the Chinese Association of Automotive Manufacturers (CAAM) show that roughly 14 million vehicles were produced from January to August of 2013. In the previous year, production in China totaled approximately 15.5 million vehicles. For comparison: roughly 5.4 million cars were produced in Germany in 2012, 285,000 of which were exported to China.

26 L. Bay, "China stützt Europas Autobauer—Mit den Flügeln des Drachen," Handelsblatt, July 10, 2013.

27 Martin Winterkorn, "Chinas Machthaber macht Volkswagen-Chef zum Top-Berater," Spiegel Online, June 5, 2013.

28 On February 1, 2013, BAIC and Daimler AG signed an agreement according to which Daimler will hold a 12-percent stake in BAIC Motor, the automobile division of BAIC. This is the first time a foreign car company has held shares in a Chinese manufacturer. It was to take place in advance of BAIC's planned initial public offering and be completed by issuing new stocks to Daimler in the course of 2013. In addition, Daimler will have two seats on BAIC Motor's supervisory board. Daimler-Benz, "Daimler AG beteiligt sich mit zwölf Prozent an BAIC Motor," press release, February 1, 2013.

29 "Following the withdrawal of Daimler's largest individual investor Aabar from Abu Dhabi, the automobile manufacturer may have found a new major shareholder in China. As the state-owned Chinese newspaper People's Daily wrote on its website on Monday, referring to insiders, the sovereign wealth fund China Investment Cooperation (CIC) seeks to purchase four to ten percent of Daimler's shares, with a market value of 1.8 to 4.5 billion euros." DPA, "Chinesen wollen offenbar bei Daimler einsteigen," Handelsblatt, January 7, 2013.

30 J. Erling, "Politisch steht Mercedes in China im Abseits," Die Welt, August 27, 2013.

It is likely to be only a matter of time before the changed worldwide locational conditions of global automobile production have an impact on German foreign trade statistics, too.

If the Chinese government succeeds in implementing its strategy, one must even anticipate a Chinese export offensive directed toward the European and other foreign markets. The German government should seriously address this development and its consequences. Time and again, as shown by the example of photovoltaic panels, China has established enormous capacity which, as soon as domestic sales begin to falter, results in major export efforts including international price wars, and this is before even considering whether government subsidies support such predatory competition.

China Invests in German High-Level and Cutting-Edge Technology Companies

If China is to continue on its path toward becoming a worldwide leader in high-level and cutting-edge technology, it will need to maintain the best possible access to foreign knowledge and technologies. Germany is a global leader in some sectors of the economy, such as automobiles and engineering, and is thus increasingly attractive for Chinese direct investments.[31]

Chinese direct investments totaling 500 billion US dollars are planned for the coming five years.[32] Some of these funds could be invested in German high-level and cutting-edge technology companies.[33] The acquisition of the German engineering company Putzmeister by the Chinese Sany Group was an initial signal of a move in this direction.[34]

Ultimately, the Chinese economy is seeking to systematically establish and expand its expertise. Hence, these acquisitions cannot be evaluated only from the perspective of individual companies,[35] as they result first and foremost from the development strategy laid down by the state and party leadership.[36] A recent study conducted by the Munich Innovation Group concludes that Chinese firms are especially interested in the expertise of German technology and market leaders in key industries as determined by the Chinese leadership.[37]

From the perspective of German economic and trade policy, it seems necessary to evaluate the situation from a cost-benefit perspective. That such a development could have an impact on the international competitiveness of the German economy cannot be ruled out. The fact that a situation does not necessarily emerge in which both sides benefit is illustrated by the example of Volvo: The Swedish commercial-vehicle corporation was taken over by a private Chinese auto manufacturer.[38] However, significant tensions with the new Chinese owners have developed since then. A particular problem is that Volvo is continuing to make high losses, and sales are declining. At the same time, Volvo's safety technology, with which the company set international standards, has been transferred to China.[39]

Lack of Free Trade Agreement a Disadvantage

The EU has already agreed on a bilateral free trade agreement with South Korea,[40] and negotiations on two further agreements between the EU and the US as well as the EU[41] and Japan[42] have begun. In a countermove, China has also entered into a number of free trade agreements. The China-ASEAN Free Trade Area[43] and the only recently concluded free trade agreement with Switzerland[44] merit particular mention.

Following the failure of the Doha Round, increasing numbers of countries are successfully negotiating bilateral agreements in order to further liberalize glob-

31 "In 2012, companies and other investors from the People's Republic will invest more in Europe than the other way around: 11 billion euros of Chinese investments on the Old Continent in contrast with seven billion euros in China. And Germany is the first choice for corporations and investors from the Far East; in no other country are the Chinese investing more money—and the trend is increasing sharply." N. Doll and J. Hartmann, "Chinesen übernehmen reihenweise deutsche Firmen,"Die Welt, December 1, 2012.

32 "China to Invest $500B in Other Nations," Bloomberg TV, June 7, 2013.

33 C. Rottwilm, "Aufschwung am M&A-Markt—Asiaten auf Einkaufstour in Deutschland," Manager-Magazin, August 13, 2013.

34 F. Mayer-Kuckuk, "Sany und Putzmeister. Die „perfekte Ehe" unter Maschinenbauern," Handelsblatt, June 14, 2012.

35 C. Jungbluth, Chinesische Direktinvestitionen in Deutschland (Bertelsmann-Stiftung, 2012).

36 N. Doll and J. Hartmann, "Chinesen übernehmen reihenweise deutsche Firmen," Die Welt, December 1, 2012.

37 Munich Innovation Group, China investiert—Patentportfolios und Investitonsstrategien chinesischer Firmen (Munich Innovation Group in cooperation with Technische Universität München, 2013).

38 H. Steuer, "Nach der Übernahme durch Geely: Chinesen treiben Volvo in die Enge,"Handelsblatt, May 9, 2013.

39 "Auto „Made in China" schafft Top Note im Crashtest," Die Welt, September 25, 2013.

40 European Commission, The EU=Korea Free Trade Agreement in Practice (Brussels: 2011).

41 European Commission, Transatlantic Trade and Investment Partnership (TTIP) (Brussels: 2013). (See the EU Commission website).

42 "EU und Japan wollen Freihandelszone," Handelsblatt, April 15, 2013.

43 "Welthandel: Ostasien schafft größte Freihandelszone der Welt," Frankfurter Allgemeine Zeitung, January 3, 2010.

44 "Verhandlungen abgeschlossen: China und die Schweiz schließen Freihandelsabkommen" Frankfurter Allgemeine Zeitung, July 6, 2013.

al trade structures at least between the countries involved. The multilateralism policy followed by the World Trade Organization to date is thus becoming less and less important.

Regional or bilateral trade agreements can cause trade diversion effects, as they implicitly disadvantage the other countries by means of higher tariffs or non-tariff trade barriers. Since such an agreement, at least between the EU and China, has not officially been on the agenda to date, this is likely to have a negative impact on the trade relations of the EU, and thus also of Germany, with China. However, the European Commission is already considering taking up such negotiations with China.[45]

Conclusion

German-Chinese economic relations have developed very rapidly during the past decade. China's high growth rate and the integration of the country into the global economy had a key role to play in spurring German exports.

In recent years, the high degree of complementarity of the product portfolios in question has played a beneficial role. For example, China supplied textiles and basic industrial goods to Germany, while Germany tended to export high-quality capital goods, such as machinery and equipment, and also road vehicles to China.

As the significance of information and communications technologies has increased, China has gradually displaced the US as a producer of these high-tech goods from the global market, although globally active multinational corporations from Japan, South Korea, Taiwan, and the US also contributed to this process. Since Germany already withdrew from this market very early on, there have only been a small number of conflicts in its trade with China. Such a case occurred for the first time over photovoltaic panels, and the next—over wind turbines—is imminent.

In other technology-intensive sectors, such as automotive and other engineering or rail and aviation technology as well as spacecraft and satellite technology, the People's Republic is undertaking massive efforts to catch up with the countries that have been leaders in these areas to date. However, this means that China will increasingly enter into competition for capital investments for the production of specific goods—with Germany, too. As a result, foreign companies manufacturing in China could be supplanted, as the Chinese state and party leadership seeks to establish an autonomous technology and knowledge base independent of foreign support.

A strategy of acquiring knowledge and expertise through Chinese direct investments in foreign companies may lead to conflicts in economic relations which European Union and German economic and trade policy should address soon. After all, the German economy's international competitiveness is based to a large extent on comparative competitive advantages in the field of high-level and cutting-edge technology which domestic companies rely on in the long term.

Georg Erber is a Research Associate in the Department of Competition and Consumers at DIW Berlin | gerber@diw.de

JEL: F14, F59, L16
Keywords: Germany, China, economic relations, trade and foreign direct investments

45 "EU denkt über Freihandel mit China nach," Frankfurter Allgemeine Zeitung, September 18, 2013.

DIW Berlin—Deutsches Institut
für Wirtschaftsforschung e. V.
Mohrenstraße 58, 10117 Berlin
T +49 30 897 89 -0
F +49 30 897 89 -200

Volume 4, No 2
14 February, 2014
ISSN 2192-7219

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