Germany's external relations with the People's Republic of China

For a number of years now China has been one of the rapidly growing emerging market economies and has now attained an important place in global economic developments. This is due both to the economic power of the country and to its increasing integration into the international division of labour, as reflected in its growing share of world trade and in the expanding investment of non-residents. Owing to the pegging of its currency to the US dollar, China has also increased its holding of reserve assets considerably in recent years. This is coming in for criticism, especially in the debate about "global imbalances".

The catching-up process is also being reflected in Germany's external relations with China. During the past few years China has become increasingly important to the German economy as an export market and a host country for inward investment; at the same time, China's standing as a supplier and competitor on the German market has increased significantly. This report describes developments in Germany's trade and international capital links with China during the past ten years, which form the focal point for this analysis. The article begins by outlining China's position in the world economy.

China's growing significance for the world economy[1]

Internal reforms and opening-up to the outside world

At the end of the 1970s a process of gradual economic change began to emerge in China against the background of the existing socialist economic regime. This ultimately paved the way for a more radical opening-up of the Chinese economy to the outside world at the beginning of the 1990s. This development was given a further boost when China joined the World Trade Organisation (WTO) in 2001.[2]

For a number of years now China has been experiencing dynamic economic growth. For example, real gross domestic product (GDP) grew, according to official Chinese data, by an annual average of 8½% between 1995 and 2004. During this period it also succeeded in fighting inflation. Whereas double-digit inflation rates were recorded during the first half of the 1990s, low inflation rates set in towards the end of the 1990s and the beginning of the present decade, and at times the price level actually decreased. Supply-side factors such as productivity gains, which were achieved as a result of increased investment[3] and the introduction of new technologies, the reduction and abolition of customs duties, changes in administrative price controls and reforms in the area of government-owned enterprises as well as the pegging of the exchange rate to the US dollar, made this stabilisation process easier. Owing to China's integration into the global economy and the progress made in liberalising prices on the domestic markets, prices in China are being determined increasingly by the market. In addition, rapid convergence with international prices occurred in the field of tradable goods.[4]

China's growing significance for global GDP and world trade

In terms of GDP, China is now the seventh-largest economy (at current prices and exchange rates). In 2004 the country achieved a 4% share of world output; if measured in terms of the IMF's purchasing power parities, this share is actually almost 13%. Consequently, the dynamic expansion of the Chinese economy is making an important contribution to the growth of the world economy. In terms of purchasing power parities, this is likely to have contributed about one-quarter of the 5% increase in global output in 2004.

These figures are essentially attributable to the growth strategy, population size and China's other factor endowments. Even so, it must not be forgotten that China's per capita GDP is still relatively small at around US$1,300 (at current prices). By comparison, the per capita income of Latvia, the poorest EU member state, is more than four times as great at around US$5,800.[5]

1 In this report the term "China" refers to the territory of the People's Republic of China excluding the special administrative regions of Hong Kong and Macau.
2 See E Prasad (Ed, 2004), China's Growth and Integration into the World Economy, IMF Occasional Paper 232, p 2.
3 The investment ratio, ie the relationship between investment and GDP, has averaged around 40% during the past ten years.
4 See Prasad (2004), *loc cit*, pp 14-20.
5 The corresponding figure for Germany is around US$32,700. In terms of purchasing power parities, per capita GDP in 2004 amounted to approximately 5,600 units for China, according to calculations by the IMF, and to 11,800 and 28,900 units for Latvia and Germany respectively.

Macroeconomic variables of the People's Republic of China

Item	1995	1998	2001	2004
GDP in US$ billion	700.2	946.3	1,175.7	1,649.4
Percentage share of world GDP expressed in purchasing power parity terms	8.8	10.2	11.5	13.2
Per capita GDP expressed in purchasing power parity terms	2,495.9	3,263.0	4,211.4	5,641.6
Per capita GDP in US dollars	578.1	758.5	921.2	1,268.7
(Nominal) percentage share of world trade	2.7	2.9	4.1	6.4
Current account balance in US$ billion	1.6	31.6	17.4	68.6
Current account balance expressed as a percentage of GDP	0.2	3.3	1.5	4.2
Foreign exchange reserves in US$ billion	73.6	145.0	212.2	609.9
Percentage share of world foreign exchange reserves	5.3	8.8	10.3	16.4
Population (million)	1,219.4	1,253.9	1,285.2	1,299.9
	1995–1999	2000–2004	1995–2004	2004
	Percentage change from previous year 1			
Real GDP	8.8	8.5	8.6	9.5
Consumer price index	5.2	1.1	3.1	3.9
Exports of goods (nominal)	10.4	25.3	17.9	35.4
Imports of goods (nominal)	7.7	28.2	18.0	36.0

Sources: IMF, IFS and WEO Database; National Bureau of Statistics of China; State Administration of Foreign Exchange, China; Bundesbank calculations. — **1** Average of the annual change.

Deutsche Bundesbank

Integration boost through WTO accession

China's integration into the global division of labour was given a further boost with its accession to the WTO in 2001. Export growth and import growth have both accelerated since then and are generating important stimuli for world trade developments as well. In 2004 Chinese exports and imports of goods rose by 35½% and 36% respectively. Consequently, China contributed a share of more than 2 percentage points to the (nominal) growth in world trade. China's share of (nominal) world trade now amounts to almost 6½%, making it the third-largest trading nation after the United States and Germany. China's rapid integration into the world economy is also reflected in the increasing degree of openness of the Chinese economy. At around 35% in 2004, this degree of openness was more than twice as high as it had been at the beginning of the 1990s.[6] The trade balance has been showing a surplus for years; in 2004 this surplus amounted to about 2% of GDP.

Around 56% of Chinese exports went to industrial countries in 2004. The United States absorbed the greatest share of these (about 23%), followed by the euro area (13½%) and Japan (12½%). Another important region for Chinese exports is Asia (excluding Japan), which absorbed just under 32% of China's exports. Trading links with Hong Kong are particularly well developed (16%); this is a reflection not only of geography and the political situation but probably also Hong

6 The degree of openness is calculated as the average of the exports and imports of goods in relation to GDP.

Kong's role as an international port.[7] Customers in the industrial countries also regard China as an important source of imports now. For example, China's market share in terms of total imports amounted to more than 20½% in Japan in 2004, to just over 13½% in the United States and to just under 4½% in the euro area (see the table on page 39).

The Chinese attach great importance to suppliers from the industrial countries. About 40% of China's imports came from the industrial countries in 2004; Japan is the most important supplier (16%), followed by the euro area (10½%) and the United States (7½%). Of the other neighbouring Asian countries, South Korea (10½%) and Hong Kong (7½%) have been the most successful in enhancing their position on the Chinese market. In the past decade Chinese importers have become increasingly important for the industrial countries, and for some developing countries in Asia, in particular. For example, more than 13% of Japan's exports went to China in 2004; in the case of the United States the corresponding share was just over 4½% and in the case of the euro area it was just under 2%. At 44%, China's share of Hong Kong's exports was very large and for the reasons mentioned above. Even so, China has also become an important market for South Korea, Malaysia and Singapore.

New export market and new competitor

While economic developments in China and the progressive opening-up of the country to foreign trade are providing new sales opportunities for suppliers in other countries, they are also intensifying competition in many markets. China has enormous comparative advantages in the case of labour-intensive products. During the past 20 years it has greatly diversified the range of its export goods and has improved the quality of its products. In some segments it has now achieved a significant market position. For example, China's share of cross-border trade in toys is now about 30%.[8] Radical changes are also being made in the textiles and clothing sector. The Agreement on Textiles and Clothing, which had restricted China's exports in this sector by means of quotas, expired at the end of 2004. Despite that, China had already achieved a 20% share of this market by 2003. It is estimated that China could increase its position in this sector to more than 50% in the short term.[9] The liberalisation of imports in the textiles and clothing sector has already resulted this year in some industrial countries taking first steps to protect themselves against what they consider to be excessive market penetration by Chinese suppliers. China's growing importance in world trade will possibly result in a painful adjustment process in some sectors and regions in the short term, although in the medium to long

7 As many goods find their way to and from China via Hong Kong, it may be assumed that the bilateral trade flows between China and other countries are being understated in some cases.
8 China has increased its export share of many categories of globally traded goods since the beginning of the 1990s. Growth in office and telecommunications equipment as well as in travel goods, furniture, toys and textiles has been particularly brisk whereas the significance of raw materials has declined. The part played by high-tech goods has also been growing recently. See IMF (2004), World Economic Outlook April 2004, p 84.
9 See H K Nordas (2004), The Global Textile and Clothing Industry Post the Agreement on Textiles and Clothing, WTO Discussion Paper No 5 and E Heymann (2005), Nach Ende des Welttextilabkommens: China reift zur Schneiderei der Welt, DB Research Aktuelle Themen, No 310.

Developments in China's foreign trade

%

Countries	1995	1998	2001	2004	1995	1998	2001	2004
	Breakdown of China's exports of goods							
	Trade with selected countries and groups of countries as a percentage of China's total exports				Chinese exporters' share of the markets 1 of selected countries and groups of countries			
Industrial countries	51.4	55.3	55.8	56.1	3.7	4.5	5.9	8.1
United States	16.6	20.7	20.4	22.8	6.3	8.0	9.3	13.7
Japan	19.1	16.2	16.9	12.4	10.7	13.2	16.6	20.7
Euro area	10.6	12.2	12.1	13.7	1.8	2.3	2.9	4.3
Germany	3.8	4.0	3.7	4.0	2.4	2.8	3.7	5.7
United Kingdom	1.9	2.5	2.5	2.5	1.2	1.6	2.7	4.2
Developing countries in Asia	40.1	34.5	32.9	31.8	9.5	11.5	11.7	11.7
Hong Kong	24.2	21.1	17.4	16.2	36.2	40.6	43.4	43.5
South Korea	4.5	3.4	4.7	4.4	5.5	6.9	9.4	12.3
Malaysia	0.9	0.9	1.2	1.3	2.2	3.2	5.2	9.9
Singapore	2.3	2.1	2.2	2.2	3.2	4.8	6.2	9.9
Memo item								
Oil exporting countries 3	2.7	2.7	3.7	3.6	3.3	3.6	4.5	7.4
	Breakdown of China's imports of goods							
	Trade with selected countries and groups of countries as a percentage of China's total imports				Importance of China as an export market 2 for selected countries and groups of countries			
Industrial countries	55.4	51.6	48.2	40.2	1.7	1.6	2.2	3.4
United States	12.2	12.1	10.8	7.7	2.0	2.1	2.6	4.3
Japan	21.9	20.2	17.6	16.1	5.0	5.2	7.7	13.1
Euro area	13.6	11.7	12.1	10.4	1.0	0.9	1.2	1.8
Germany	6.1	5.0	5.6	5.4	1.4	1.2	1.9	2.9
United Kingdom	1.5	1.4	1.4	0.8	0.5	0.5	0.9	1.3
Developing countries in Asia	33.7	37.5	35.4	40.8	8.2	8.5	9.4	13.7
Hong Kong	6.5	4.7	3.9	7.4	33.3	34.5	36.9	44.0
South Korea	7.8	10.7	9.6	10.4	7.0	9.0	12.1	22.4
Malaysia	1.6	1.9	2.5	2.8	2.6	2.7	4.3	6.7
Singapore	2.6	3.0	2.1	2.6	2.3	3.7	4.4	8.6
Memo item								
Oil exporting countries 3	2.9	3.5	5.1	4.6	1.5	1.7	3.1	4.8

Sources: IMF Direction of Trade Statistics (in accordance with country classification), Federal Statistical Office, Bundesbank calculations. — **1** Imports from China as a percentage of the overall imports of the given country and region. — **2** Exports to China as a percentage of the overall exports of the given country and region. — **3** OPEC countries and Oman.

Deutsche Bundesbank

term it will provide an opportunity to accelerate a structural change that will increase prosperity.[10] Trade restrictions may therefore not be the right answer to these frictions, especially as Germany – like other industrial countries – is already reaping enormous benefits from its intensive trade with China. To see China as simply an extended workbench for low-tech products is short-sighted. Chinese enterprises are already often suppliers of – and customers for – fairly high-quality products.

Foreign direct investment as part of growth strategy

China's development potential is being enhanced not least by the import of foreign expertise. Direct investment plays a particularly important role here; it is a key component in China's catching-up strategy.[11] By granting privileges and concessions (for example, in the field of taxation) for foreign direct investment as well as setting special general conditions, policy makers in China have been aiming to attract foreign capital and thereby to promote the country's process of development and growth.[12] According to preliminary estimates made by UNCTAD, foreign suppliers of capital undertook direct investments amounting to US$62 billion in China in 2004. That was the equivalent of just under 4% of Chinese GDP. This means that China attracted about 10% of international direct investment capital (or almost 25% of the capital invested in developing countries) and ranked second (after the United States) in the league of global recipients of direct investment funds.[13] In 2003, the last year for which disaggregated data are available, about 63½% of the FDI flowing into China came from Asia.[14] Hong Kong played a particularly leading role with a 33% share of the total direct investment amount.[15] Not only enterprises from Japan (9½%) and South Korea (8½%) but also enterprises from the United States and Europe were active to an similar extent in the Chinese market (about 8% each). The bulk of foreign direct investment was concentrated on manufacturing; the real estate and land sector attracted the second-largest share of funds from foreign investors.

In terms of direct investment stocks, which provide a comprehensive picture of past direct investment activity, the amount invested at the end of 2003 was just over US$500 billion; that was equivalent to over 35% of Chi-

10 Most studies which try to estimate the effects of China's accession to the WTO come to the conclusion that this will lead to greater prosperity for China and the rest of the world. The degree to which individual countries benefit depends on the extent to which their product range complements that of China. Suppliers competing with Chinese producers in labour-intensive sectors are likely to be disadvantaged. See IMF (2004), *loc cit*, p 90 ff
11 See J Aziz and Ch Duenwald (2002), Growth-Financial Intermediation Nexus in China, IMF Working Paper 02/194.
12 Since the late 1970s a legal framework has been gradually created which has laid down and expanded the conditions for foreign direct investment (eg authorised proprietor structure, constraints in the open trade areas, promotion of direct investment that is export-oriented and directed at specific sectors). For an overview see W Tseng/H Zebregs (2002), Foreign Direct Investment in China: Some Lessons for Other Countries, IMF Policy Discussion Paper 02/3, p 12 ff and OECD (2002), China in the World Economy, p 330 f
13 See UNCTAD (2005), World FDI Flows Grew an Estimated 6% in 2004, press release of 11 January 2005.
14 See Statistical Yearbook of China 2004, p 732 ff
15 However, aggregate flows of foreign direct investment funds into China are probably overstated to some extent. This is partly attributable to the "round-tripping" of capital. The Chinese use the privileges granted for foreign direct investment by investing their capital in the form of direct investment. According to an UNCTAD study, Hong Kong and the British Virgin Islands are particularly involved in this cross-border transferring and retransferring of capital. See D Aykut/D Ratha (2003), South-South FDI Flows: How big are they?, UNCTAD Transnational Corporations, Vol 13, No 1, pp 163 ff. In 2003 just under 11% of the direct investment funds originated in the British Virgin Islands.

nese GDP. At the beginning of the 1990s this variable had amounted to just under 6%.

Production cost advantages and market access the most important motives

Direct investment not only helps to transfer expertise and extend development potential; it can also directly promote the international division of labour and – depending on the motives behind direct investment – can stimulate foreign trade. This evidently applies to China, too. About half of Chinese exports in 2002 were attributable to the subsidiaries, participating interests and joint ventures of foreign firms in China.[16] Not only market access but also the exploitation of production cost advantages are important motives for foreign investors in China.[17]

Increase in reserve assets

Although China has become a significant host country for direct investment funds, it has also been exporting increasing amounts of net capital recently. In 2004 China lent net savings of US$68½ billion to the rest of the world; that is equivalent to about 4% of national GDP.[18] In practice, the main source of this provision of funds is the accumulated foreign exchange reserves; at the end of 2004 China had almost US$610 billion of these reserves, which is about 16½% of total global stocks. At the end of 1995 its share had amounted to just under 5½%. China's intervention on the foreign exchange markets is to be seen in the light of the pegging of the renminbi to the US dollar (see the overview of page 42). Consequently, China's exchange rate policy has assumed an important role in the international exchange rate patterns and in the "global imbalances". A change – which is under discussion – could make the adjustment process in global current account positions easier.

German current account relationships with China

China takes increasing share of German exports

China's growing integration into the international division of labour is also reflected in Sino-German trade relations.[19] In 2004 alone, German exports of goods to China rose by 14½%. This growth rate is actually lower than the rates achieved over the previous five years. German exports to China more than doubled between 2000 and 2004; within the past ten years they have increased approximately fourfold. Today, China absorbs nearly 3% of German exports of goods. This means that China has now become a more important export market than Japan or some trading partner countries in Europe.

Breakdown of exported goods

German exports to China are mainly from those sectors in which Germany is very competitive internationally. In 2004 about half of these exports came from the mechanical en-

16 See Direkt-Presseinformationen aus dem Institut der deutschen Wirtschaft Köln, Vol 30, No 58, 6 October 2004.
17 See Tseng / Zebregs (2002), *loc cit*, pp 8 ff.
18 The sum mentioned is equal to China's current account surplus. This is largely due to a positive foreign trade balance. The export of capital is also possible owing to the inflow of current transfers. By contrast, net expenditure both on services and in the field of income are reducing the current account position.
19 Figures both in the case of general data on trade in goods and in the field of invisible current transactions are calculated on an fob/fob basis; ie the freight and insurance costs payable on imports are not included in the value of the goods but are shown under services. By contrast, data for the breakdown by type of product are available only in fob/cif form. These are generally nominal variables as there are no price indices for Germany's bilateral trade flows with China.

The exchange rate and currency regime of the People's Republic of China

Up to the early 1990s, the People's Republic of China had a dual exchange rate system combining an official exchange rate with a peg of the renminbi to the US dollar and a market-based exchange rate at which, for instance, Chinese exporters and importers could trade a limited amount of foreign currencies. In January 1994 both exchange rates were replaced by a unified exchange rate of 8.7 renminbi (RMB.¥) to the US dollar. This rate corresponded to the market rate at the time. While this decision was tantamount to a devaluation of the official rate of RMB.¥5.8, it had little effect in practice, as only some 20% of all foreign exchange transactions had been made at this rate.[1]

In the next one and a half years, the renminbi appreciated by 4½% against the US currency; a de facto peg to the dollar was established in mid-1995. Since then, the Chinese currency has been quoted virtually unchanged at RMB.¥8.3 to the US dollar. The Chinese authorities have intervened massively, particularly in recent years, to uphold this exchange rate. Being tied to the US dollar, the renminbi has closely tracked all of the dollar's exchange rate movements. Consequently, after the euro was introduced in 1999, the renminbi initially appreciated, peaking at RMB.¥6.83 to the euro on 26 October 2000.[2] The Chinese currency started to decline, accelerating in the second quarter of 2002, to bottom out at RMB.¥11.28 to the euro on 28 December 2004.

On a weighted average against the currencies of China's main trading partners, the picture was very much the same. As the second half of the 1990s got under way, the development of the renminbi's nominal effective exchange rate reflected the continuous strengthening of the US dollar against some European currencies, the Japanese yen and the currencies of various East Asian economies.[3] This appreciation trend accelerated when the Asia crisis broke out, forcing several Asian countries to devalue their currencies suddenly. In the late 1990s, the external value of the renminbi temporarily slipped again in the wake of the Japanese yen's rise against the US dollar and the recovery of the smaller Asian countries' currencies. The US currency's general strength until early 2002 and its subsequent depreciation determined the development of the renminbi's effective exchange rate at the start of the new millennium.

The real external value of the renminbi, which takes into account nominal exchange rate developments as well as inflation differentials to China's main trading partners, has been largely identical with its nominal effective external value in the past decade. However, in the mid-1990s, the currency's real appreciation substantially exceeded its nominal appreciation, a consequence of comparatively high consumer price inflation in China at the time. Likewise, relatively high inflation recently has dampened the tendency of the Chinese currency to depreciate during the period of the dollar's weakness. Overall, the renminbi has depreciated by 15% in nominal and in real terms since the beginning of 2002.

Various options have been proposed in connection with the dollar peg to make the Chinese currency's exchange rate more flexible: discretionary revaluation of the renminbi against the US dollar; widening of the exchange rate bands; establishment of a renminbi peg to a currency basket and dissolution of the peg to the US dollar as the sole anchor currency; transition to a flexible exchange rate or a combination of several of these proposals.

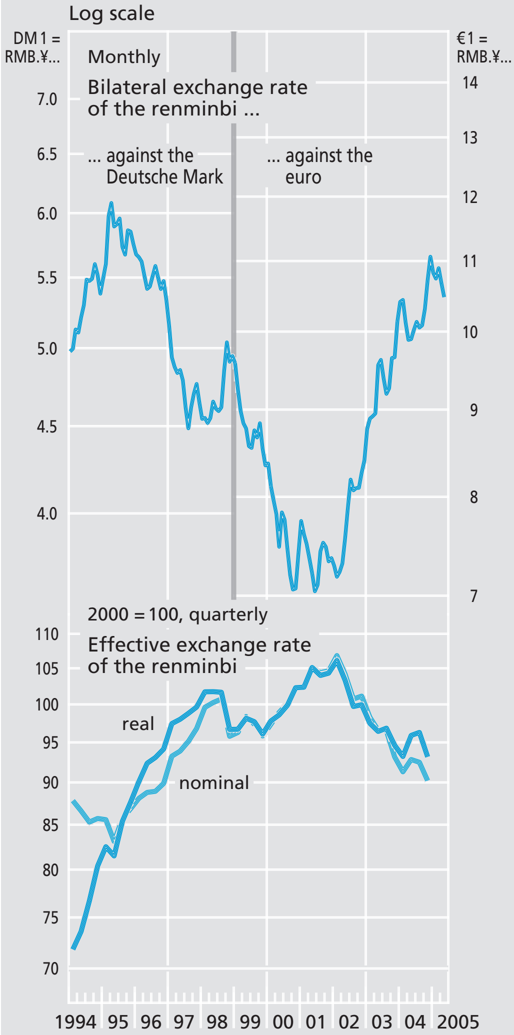
1 See N R Lardy (2002), Integrating China into the Global Economy, Washington, DC, p 193. — **2** The rates provided are the euro reference exchange rates of the ECB, which has computed and published the renminbi rate since the end of March 2005. In addition, the ECB has published rates retroactively going back to January 2000. — **3** This analysis is based on the effective exchange rate of the renminbi published in the IMF's International Financial Statistics (IFS). The IFS also contain a real exchange rate that the IMF computes on the basis of consumer prices. However, the usefulness of this real exchange rate as a competition indicator is limited, as the calculation includes non-tradable goods.

Deutsche Bundesbank

gineering sector and from the car industry. While mechanical engineering products accounted for about 14% of Germany's total exports, the ratio in trade with China – not least as a result of the rapid pace of investment there – was much higher at 35½%. A significant proportion of these export goods included machinery for the textiles and clothing industry and printing presses. The second most important component of German exports to China were motor vehicles and parts. Even so, given a share of 13%, the motor industry played a less significant role in the case of exports to China than it did in the case of German exports as a whole. This must also be seen in the light of the fact that the German motor industry's relatively extensive direct investment in China largely serves to meet Chinese demand directly through manufacturing locally. Furthermore, in 1998-99 and again last year, in particular, the sales of German car manufacturers on the Chinese market declined substantially. One reason for the current downturn may be the more restrictive lending to the private sector, which was ordered by central government as a measure to prevent the economy from overheating. Another reason is that competition in the Chinese car market has intensified recently owing to the presence of additional foreign suppliers.

Other important types of product exported by Germany to China are information and communication technology (ICT) products, metals and metal products as well as chemical products. With shares of 11½%, 8½% and 7½% respectively in 2004, however, these sectors – even if due account is taken of their respective contributions to export growth – were less significant than mechanical engineering or the motor industry. Much like the development in overall trade with China, exports by the ICT sector have increased more than fourfold within the past ten years. However, the annual growth rates in this sector have been subject to sharp fluctuations; cyclical demand factors in connection with the New Economy and the price

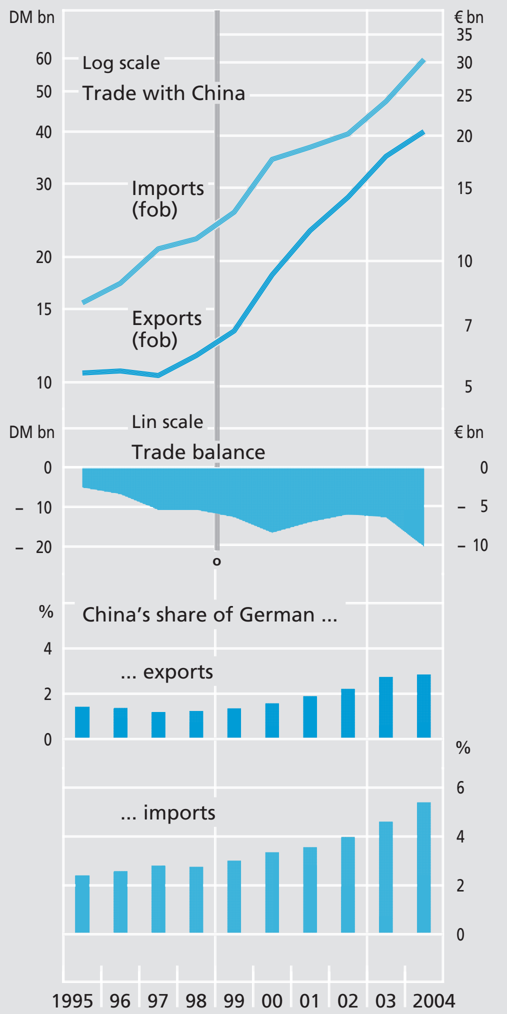
Exchange rates of the renminbi



Sources: IMF and ECB.

Deutsche Bundesbank

German foreign trade with China



o From 1999 data in euro.

Deutsche Bundesbank

changes in the case of ICT products have probably played a decisive role. Supplies by the chemical industry and the metal-working industry have been increasing at double-digit annual rates since the late 1990s. Although imports of raw materials are particularly important for China's development process, the share of chemical products in Germany's exports to China is only half the corresponding share in German exports as a whole. The enormous geographical distance and the lesser degree of China's integration into international production are possibly having a detrimental effect here. Since 2003 China has been Germany's tenth-largest customer for metals and metal products. In view of the buoyant rates of construction and investment, there is a particularly heavy demand from China for basic iron, steel, copper and aluminium (as well as for semi-finished goods made from these metals).

German imports of goods from China

German imports from China have increased even more rapidly than exports over the past few years. China is now Germany's sixth-largest foreign supplier. During the past ten years the rise in the value of Germany's imports from China has averaged 15% per year; this means that imports from China now amount to 5½% of Germany's total imports.

Breakdown of imported goods

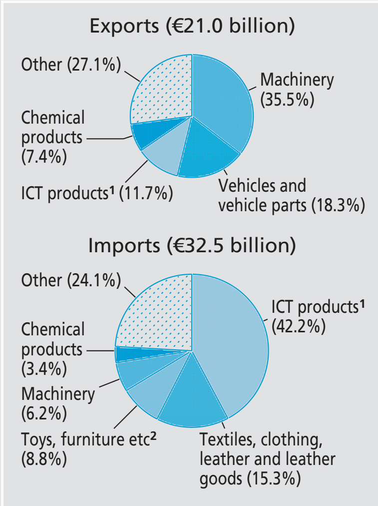
ICT products are one of the main components of German imports from China. Growth rates in this sector have amounted to up to 45% per year during the past few years. Demand has shifted in the process from television sets to IT equipment. German imports from China were also increasing discernibly in the area of textiles in the second half of 2004, ie even before the expiry of import quotas in the textiles and clothing sector at the beginning of this year. Outer garments (excluding workwear) – the most important subcategory in terms of value – increased especially sharply. Average growth rates of 26% have been recorded in this segment since 2002. In addition to dispersing competition from other countries, the partial relocation of German production to China probably also played a significant role here both in the ICT field and in textiles and clothing. This is indicated by the above-average proportions of imported intermediate goods from China.

Given the significant role played by mechanical engineering products in German exports to China, the 6% share of machinery in German imports from China and the high annual growth rate (of 27% in 2004) are considerable. While exports consisted mainly of industrial machinery, imports consisted largely of electrical household goods (and parts), which likewise belong to this segment. The significance of toys and furniture,[20] a category in which China, as already mentioned, has a substantial world market position, was somewhat greater at 9% of all German imports from China in 2004. In contrast to developments in the case of other products, however, imports of these classical consumer goods are declining both in terms of value and in terms of their total share, a situation which presumably is a reflection not least of the persistent weakness in private consumption in Germany.

Trade balance

Prior to 1995 Germany was already running a deficit in its trade in goods with China, and this deficit has continued to grow with the exception of the years 2001 and 2002. In 2004 it peaked at €10 billion. However, in view of Germany's large overall trade surplus, which in 2004 amounted to €156 billion when calculated on an fob/fob basis, the deficit with China is of relatively minor importance. It is equivalent to about ½% of German GDP.

Breakdown of goods in German foreign trade with China in 2004



1 Information and communication technology products. — **2** This category of goods includes sport equipment, jewellery and musical instruments.

Deutsche Bundesbank

Invisible current account transactions

China's role in Germany's invisible current account transactions with non-residents is much less important than its role in trade in goods. Apart from 1998 and 1999, the balance in this area was entirely positive from Germany's point of view and exceeded €1 billion only in 2003. Germany's bilateral current account balance with China is therefore essentially determined by foreign trade. In 2004 a deficit of €9½ billion was recorded.

Services

In the period from 1995 to 2001 the Sino-German services account continuously ran a deficit. It was not until the past three years that Germany achieved a surplus. Foreign travel and transport constitute the most important items within the services account. Ex-

20 This category of goods includes sports equipment, jewellery and musical instruments.

Germany's current account vis-à-vis the People's Republic of China

€ billion

Item	1995	1998	2001	2004
1 Trade in goods [1]				
Exports (fob)	5.5	6.0	12.0	20.8
Imports (fob)	8.1	11.5	19.1	31.0
Balance	– 2.6	– 5.5	– 7.1	– 10.2
2 Services				
Receipts (fob)	0.4	0.6	1.1	1.9
Expenditure (fob)	0.4	0.8	1.2	1.7
Balance	– 0.0	– 0.3	– 0.1	+ 0.2
3 Income (balance)	+ 0.2	+ 0.3	+ 0.3	+ 0.7
4 Current transfers (balance)	– 0.0	– 0.1	– 0.1	– 0.1
Balance on current account	– 2.4	– 5.5	– 6.9	– 9.4

1 Special trade according to the official foreign trade statistics (source: Federal Statistical Office), including supplementary trade items but excluding freight and insurance costs.

Deutsche Bundesbank

cept for the year of the SARS epidemic (2003), foreign travel expenditure has accounted for between 20% and 30% of Germany's total expenditure on services in China since 1991. Consequently, it forms by far the largest item on the expenditure side of the bilateral services account with China – as it does in the German balance of payments as a whole. The expenditure of German residents on travel in China in 2004 amounted to an estimated €½ billion; this means that it was almost equal to German expenditure on travel in Portugal and was several times more than the corresponding expenditure by Chinese in Germany.

Among the other larger expenditure items featuring on the services account for years are the overhead expenses[21] incurred in connection with direct investment – although these have become (relatively) less important recently – and the commercial services, which have gained in importance since the late 1990s. By contrast, the largest receipts from Germany's point of view came from transport. Since the mid-1990s receipts from transport have averaged 32½% of the total income arising from the provision of services to China. Particularly in the past two years income from engineering and other technical services[22] as well as from IT services has also become increasingly important. These developments reflect the rapid growth in bilateral trade and the buoyant level of investment in China.

Income and current transfers

The Sino-German exchange of factor services has been characterised by net inflows of funds throughout the entire period from 1995 to 2004. Of particular importance in this connection are income from direct investment in China and interest on loans. By contrast, the current transfers made to China constantly exceeded the corresponding income during the same period. This was due mainly to private transfers although the amount involved was very small.

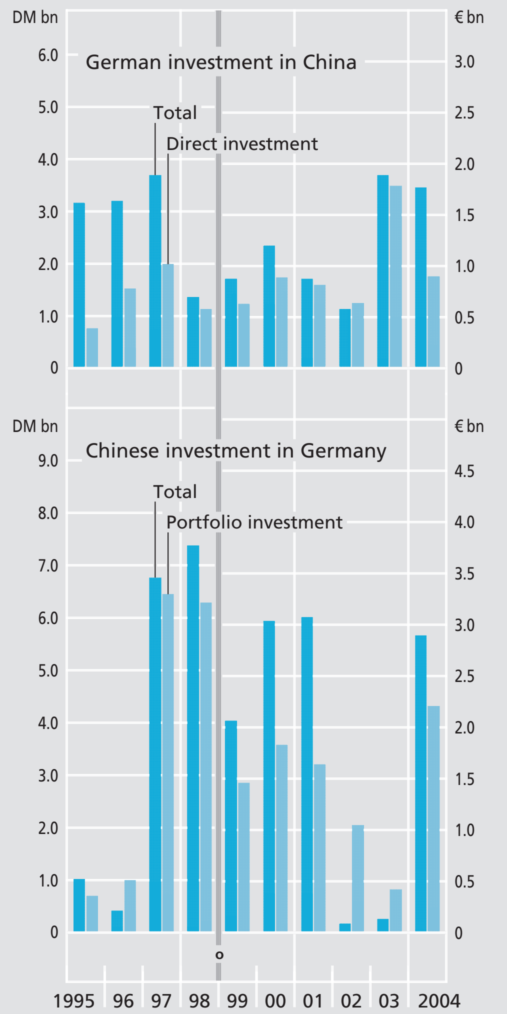
21 Overhead expenses are payments by subsidiaries to their parent company for pro rata expenditure and grants to subsidiaries, branches and operating plant to finance current business operations.
22 Engineering and other technical services include fees for planning and designing technical products, for technical ground work and technical assistance, for information, consultancy and training in technical and scientific fields (but excluding the separately listed IT services).

German financial transactions with China

German investment in China

The transformation of the Chinese economy has attracted a considerable amount of foreign capital. German residents, too, have invested in China. Starting from a very low level, German capital flows to China began to rise in the mid-1990s from less than €½ billion (1993) to almost €2 billion (1997). However, German capital exports to China were curbed as a result of the Asia crisis, which also affected China indirectly. In addition, the generally greater reluctance on the part of German residents to invest abroad after the New Economy lost steam and the terrorist attacks of 11 September 2001 made its mark. In the end, capital exports for investment purposes totalled approximately €13 billion between 1995 and 2004; however, that means that they accounted for only ½% of Germany's total capital investment abroad. In Germany's cross-border financial transactions with China it was primarily direct investment – alongside lending – that gained somewhat in importance (€8½ billion in aggregate). Consequently, German enterprises accounted for about 2½% of total global direct investment in China in the period under review.

German financial transactions with China



o From 1999 data in Euro.

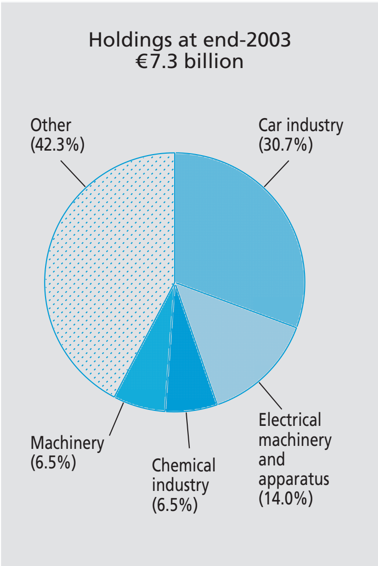
Deutsche Bundesbank

German direct investment in China – motives and economic relevance

The great expectations with regard to the economic outlook for the Chinese economy are presumably reflected in the growing presence of German enterprises in the country, a perception which is no doubt encouraged by China's accession to the WTO and the associated liberalisation measures. However, the need to catch up in the adoption of international standards can be seen, for example, in the guaranteeing of legal certainty for foreign investors.[23] According to a survey conducted by the German Chamber of Industry and Commerce in the spring of 2005, investment by German enterprises in China is much more heavily directed towards the creation of local production capacity than is the case with German direct investment in other host countries. Furthermore, great importance is

23 See Tseng and Zebregs (2002), *loc cit*, p 18.

German direct investment in China by economic sector of the investor



Deutsche Bundesbank

attached to cost advantages in the production process even though this motive is of greater significance in the case of investment in the new EU countries.[24]

Sectoral breakdown of German direct investment in China

Enterprises involved in the production of motor vehicles were the main investors in China. At the end of 2003 they accounted for 30½% of all German direct investment in the country.[25] Firms involved in the manufacture of plant and machinery to generate and distribute electricity (14%) as well as enterprises both in the chemical industry and mechanical engineering (each with a 6½% share) invested to a considerable extent (see the chart above). While this means that manufacturing enterprises have an above-average share of investment in China (when seen in terms of Germany's total outward direct investment), the part played by financial intermediaries in direct investment in China is negligible (2%). However, the differences in the relative importance of various sectors when it comes to German investment in China and elsewhere can only be partly explained by specific economic conditions in China. These differences are much more a reflection of the fact that investment there has so far been highly regulated in many respects and that this still applies to some extent. However, China's accession to the WTO has far-reaching implications, especially for investment in the services sector, which has been very restrictive until now. The liberalisation efforts in this area will probably change the relative importance of individual sectors for German investment in future, too.[26]

China of little relevance for German portfolio investors

Access to the equally very highly regulated Chinese securities markets and the limited supply of freely negotiable shares have resulted in the share of Chinese equities and coupon securities in German investors' portfolios being virtually non-existent. German securities purchases in China in 2004 amounted to less than €½ billion net compared with total German securities purchases abroad totalling just under €113 billion.

24 Deutscher Industrie- und Handelskammertag: Investitionen im Ausland – Ergebnisse einer DIHK-Umfrage bei den Industrie- und Handelskammern Frühjahr 2005.
25 The figures on the level of German direct investment in China on which this sectoral analysis is based are currently available up to the end of 2003; See Deutsche Bundesbank, International capital links, Special Statistical Publication 10, April 2005.
26 Since China became a member of the WTO, foreign credit institutions have been able to accept deposits in China and grant loans although until 2003 this was still restricted to transactions in foreign currency. Business with Chinese in local currency and the repeal of restrictions on setting up foreign subsidiaries will not occur until 2007; see OECD (2002), *loc cit*, p 752.

Importance of China for German commercial banks

The remaining restrictions, not to mention the higher weighting of the risks involved in investing in China following the Asia crisis, have meant that China is still not playing any significant role in the lending operations of German banks. The consolidated claims of German credit institutions and their foreign branches therefore show for the end of 2004, too, that China, with liabilities of around €6½ billion vis-à-vis German banks, did not even account for ½% of their relevant total foreign claims. Even so, according to the figures from the Bank for International Settlements (BIS) for the end of December 2004, the share of German banks amounted to approximately 10% of all the claims on China of credit institutions reporting to the BIS.

Chinese investment in Germany

At €19½ billion net, Germany's capital imports from China between 1995 and 2004 were about 1½ times the sum of German investors' assets in China. Furthermore, Chinese investors had other priorities when making investment decisions. They invested more than four-fifths of their investable funds in the German securities market, with the largest inflows occurring between 1997 and 2001 and again in 2004.[27] There was a demand for, among other things, money market paper and bank debt securities. By contrast, Chinese interest in direct investment in Germany between 1995 and 2004 was very low (€½ billion) but was in line with China's state of development.[28]

Outlook

Despite its comparatively low per capita income, China, on the whole, is already of great importance for world trade, global output and world currency patterns. Accordingly, China's importance for German foreign trade and – albeit to a lesser extent – as a host country for German enterprises' outward investment have increased markedly. Given the fact that China has been developing more slowly than the industrial countries, its impact on global output may help to smooth global economic cycles, thereby helping to stabilise foreign demand from a German point of view. With China's growing integration into the global division of labour, however, a stronger cyclical synchronisation with the rest of the world is to be expected. China will probably strengthen its economic position further in the next few years. According to estimates by the IMF, the country's process of integration into the world economy, if compared with other examples of the rapid integration of emerging economies, has so far been entirely consistent with the usual pattern; however, the effect on the global economy is very much more pronounced. China has the potential to make radical changes to the economically exploitable factor endow-

27 Only the direct purchases of securities in Germany by the Chinese are included in these figures. It is possible that even more funds flowed into Germany from China via international financial centres and that these could not be correctly attributed to China in the statistics.
28 Chinese direct investment abroad is still very low. In 2003 it amounted to 2½% of GDP. Strategically, however, it plays an important role. A case in point is the recent purchase of IBM's personal computer division by the Chinese Lenovo group and investments in raw materials. See WTO (2005), Developing countries' goods trade share surges to 50-year peak, press release 401, 14 April 2005.

ments worldwide and the allocation of resources, with noticeable effects on various regions and sectors.[29] It is therefore also to be expected that Germany's external relations with China will intensify further and that China will be able to further strengthen its role as an important export market as well as representing a competitor for German enterprises. If China is to be successful in pursuing its growth path, however, it will be of paramount importance that China accompanies its growing influence on the world economy with appropriate and timely reform measures internally and in its external relations.

29 See IMF (2004), *loc cit*, p 86.