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sip Strategic Intervention Paper

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Germany – Not China's Economic Pawn

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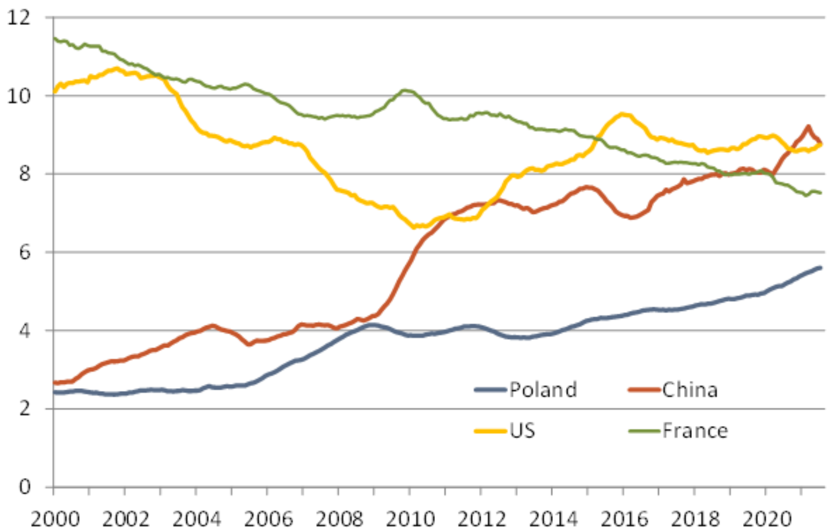
- China matters. It remains a key engine of global growth.
- But Germany and Europe are not weak either, despite the corona-related setback. Ultimately, China needs Europe even more than vice versa.
- Vis-à-vis China, Germany is strong enough to act in accordance with its values. It does not need to overlook serious Chinese transgressions to safeguard economic interests.
- By working closely with the European Union and the Biden administration, Germany can leverage its influence and reduce its vulnerability to Chinese threats.

While Germany, just as the other European economies, has had to contend with the fallout from the pandemic, China initially rebounded strongly from spring 2020 onward. Chinese demand for German exports thus became an important support for the recovery in export-oriented Germany.

Chart 1: Share in German goods exports, in %



12-month rolling averages. Source: Destatis

How much room of maneuver does Germany have?

At first glance, this may suggest that Germany should not even try to stand up to an economically powerful and ever more assertive China. Doing so could even be seen as economically self-defeating for Europe's economic powerhouse. Even though U.S.-German relations have started to improve under the President Biden, the disruptive experience with the Trump administration shows that the European Union in general and Germany in particular need to work more closely with China as the United States is longer the fully reliable partner it used to be.

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However, these narrow and short-sighted economic arguments do not stand up to scrutiny.

Are principles just “nice-to-haves”?

As a general matter, attempts to strengthen mutually beneficial economic ties are most welcome. But when it comes to relations with dictatorships such as China and Russia, this raises a fundamental question: To which extent can – or should – German policymakers and the country as a whole afford to uphold values such as human rights, freedom, democracy and respect for international treaties in their dealings with China and Russia?

“Germany does not need to overlook serious Chinese misbehavior to safeguard its economic interests.”

A closer look at the evidence suggests that the economic restraints on Germany’s room of maneuver in international relations are less binding than is often assumed. Due to its inherent economic strength and its firm anchoring in the European Union, Germany is in a position to act in accordance with its values. It does not need to overlook serious Chinese misbehavior to safeguard its economic interests.

This does not mean that Germany and the EU should use trade sanctions as the instrument of choice in order to make it more costly for China to flout global rules. Depending on the nature and severity of the issue at hand, other instruments such as personal financial and travel sanctions against Chinese officials and business leaders involved may be at least as suitable.

The key point is that Germany need not shy away from taking a clear and principled line because of the potential commercial repercussions if China were to react to such pressure by reducing access to its own market. Resisting an erosion of global rules of trade and behavior – ideally within the framework of the EU and jointly with the United States – is in Germany‘s own long-term interest.

Germany’s economic size and leadership role

As the largest economy in Europe with 25% of European Union GDP, Germany has more than an implicit leadership role in the EU. Germany remains the financial anchor of the Eurozone. If Germany is ready to use its weight and strike a deal with France, as it did last summer over an unprecedented €750 billion support program for EU members hit hard by the corona pandemic, it can shape policies in Europe.

Countries around the world, including China, know that their commercial relations with Europe depend not just on choices made in Brussels, but also on those prepared or made in Berlin and Paris.

Moreover, the German economy is deeply resourced. Its rapid recovery from the financial crisis of 2008/2009, its resilient labor market, its exceptionally strong fiscal position and the fact that is weathering the economic fallout from the Covid-19 pandemic less badly than most other advanced countries highlight its strengths.

Germany could thus withstand the potential blowback from a China displeased with a more principled course of action on the part of the German government.

The European leverage

This assessment is based on three simple observations:

First, size matters. The European Union is the top global trading power. Its exports of goods and services surpass those of the United States and China in the percentage share of global exports – see Chart 2. In 2019, its imports of €2.83 trillion surpassed that of the United States, at €2.77 trillion.

Editorial Note:

1. You can quote from this “Strategic Intervention Paper” (SIP) provided you mention the author and also refer to the Global Ideas Center.
2. We also ask that you mention that this short study, part of our “Germany in Europe” project, was funded by the Mercator Foundation.

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And although the data for the pandemic year of 2020 show a significantly stronger Chinese position, the current bounce back of the United States and European economies as vaccination programs have advanced sufficiently to relax restrictions on business activity is starting to put China's 2020 advance into perspective again.

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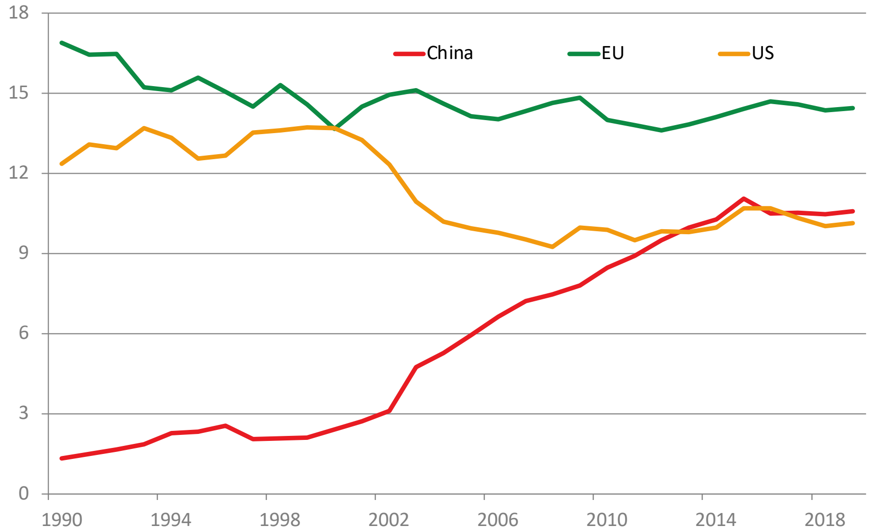
Chart 2. Share in global exports, in %



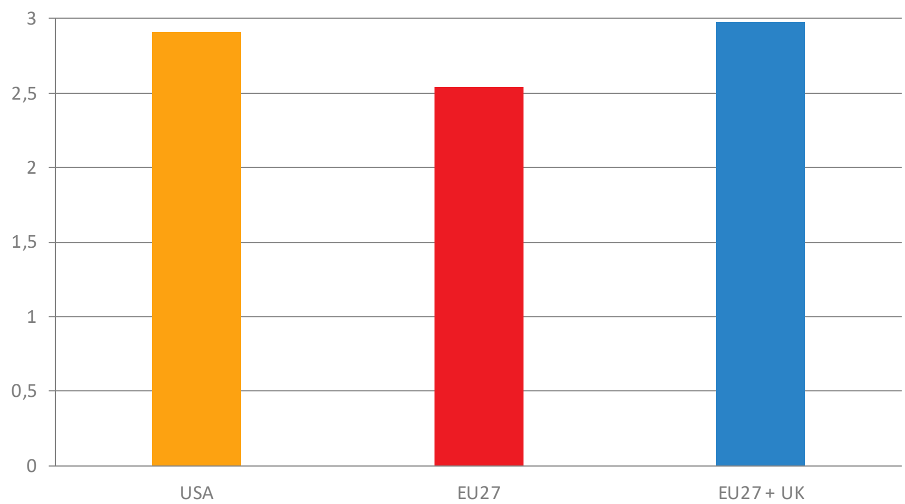
Source: OECD, Eurostat

Second, China needs the European market even more than the other way around.* For China, the European Union is almost on par with the United States as a major export market. In 2019, China earned 2.6% of its GDP by exporting goods to the EU. (Including the United Kingdom, the share would have been 2.9%, in line with that of the U.S. – see Chart 3.)

"China needs the European market even more than the other way around. China earned 2.6% of its GDP by exporting goods to the EU. For the EU goods exports to China equaled merely 1.4% of its GDP in 2019."*

For the EU, however, goods exports to China equaled merely 1.4% of its GDP in 2019 – see Chart 4. However, the data likely understate China's reliance on the EU and U.S. consumer market significantly. After all, many Chinese goods are exported to other countries where they are then assembled into finished products to be sold in the EU and the U.S. markets. In a trade conflict between the EU and China, producers in these other countries may well decide to reduce their reliance on inputs from China and substitute them by inputs from other sources.

Chart 3: Chinese exports to US and Europe in % of Chinese GDP



2019 data. Source: International Monetary Fund

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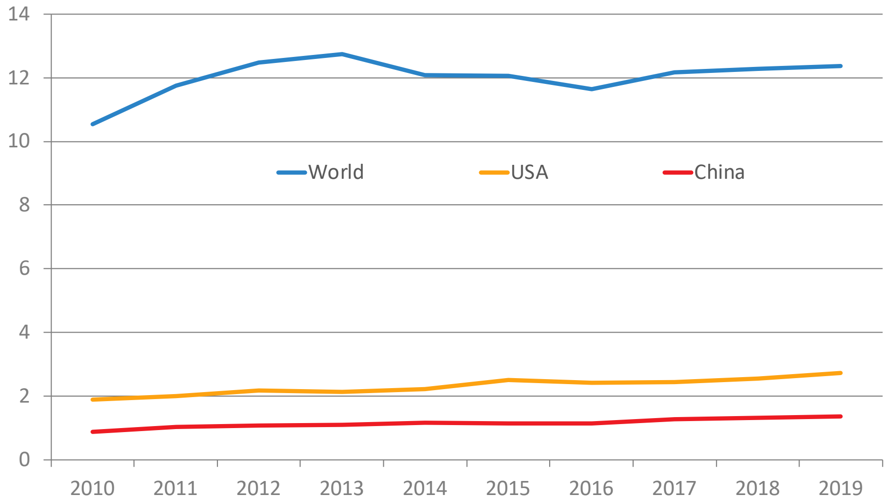
Chart 4: EU exports to China and US in % of EU GDP



Source: Eurostat

China is spending vast resources to develop its own internal market, often with domestic credits to finance public infrastructure projects with diminishing returns. Even so, China remains heavily dependent on selling manufactured exports to the world.

"Sacrificing valuable growth opportunities to raise living standards faster through deeper commercial relations with other countries will hurt China more than it would hurt the United States or Europe."

With the new five-year plan which China's "People's Congress" rubberstamped in March 2021, China is trying to reduce its dependence on external markets by developing a "dual circulation" model. But economic independence comes at a price. For all its impressive successes to date, China remains far poorer than the United States and Europe. Sacrificing valuable growth opportunities to raise living standards faster through deeper commercial relations with other countries will thus hurt China more than it would hurt the United States or Europe.

Third, the geostrategic rivalry between China and the United States will make it increasingly, difficult for China to develop deeper economic relations with the U.S. Even the switch from the Trump to the Biden administration does not seem to make a major difference in this regard.

Since taking office, President Biden has taken a firm line toward China. His administration seems inclined to act in a more coherent and principled fashion vis-à-vis China, i.e., in the same manner that is presented in this Strategic Intervention Paper – as a policy choice that Germany and the European Union can afford.

In addition, all indications are that the new U.S. administration would probably very much welcome a German stance that goes beyond short-term commercial considerations and is based on principles.

In addition, a firm approach to China is also one of the rare issues with a strong bipartisan consensus in the U.S. Congress. Many U.S. politicians complain about China's sometimes unfair trade practices, its theft of intellectual property, its treatment of the Uighurs, the breach of its obligation to respect civil liberties in Hong Kong as enshrined in an international treaty as well as its threats against Taiwan.

This, in turn, heightens the weight which China needs to attach to its commercial and political relations with Europe.

By the same token, the firm U.S. line also increases Europe's power to influence China's broader policy decisions. The more Germany uses its weight to forge a common U.S.-EU position vis-a-vis China, the more it can achieve. A common U.S.-EU approach to China would make it much more difficult for Beijing to play its trading partners against each other, for instance by threatening to favor one over the other.

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"China often seeks to position itself as a responsible global player. Such assertions, however, must be based on actually accepting and following global rules."

"In practice, China under Xi Jinping only seems to follow rules and generally accepted norms of behavior as it sees fit. China often signals severe displeasure whenever any country, company or even sports stars speak up for human rights in China."

"Unless Germany accepts its leadership it would be futile to hope for weaker countries to hold China to global and respect for human rights."

The interim conclusion for Germany is obvious: Even more so than before when German policy makers had to contend with the erratic Trump administration, they are now in a good position to emphasize their nation's principles in their dealings with China – if they so choose.

Trade as a two-way street

Economic theory and experience strongly suggest that trade based on the respect for rules and property rights, including intellectual property rights, benefits both sides. Using commercial relations as a tool to achieve non-economic goals does carry economic costs. Sanctions usually hurt both sides.

In a superficial analysis, this would suggest that it would be wise for Europe in general, and Germany in particular, to soft-ball China.

However, these arguments need to be put into proper perspective:

First, the promise to ease access – or, conversely, the threat to restrain access – to one's domestic market is the standard carrot-and-stick approach to commercial negotiations with other countries. For example, the EU27 used this approach quite ruthlessly in 2020 much closer to home, in the negotiations with the United Kingdom over a post-Brexit trade deal.

Second, the U.S. and China have increasingly linked commercial relations to other political goals in recent years. Europe – and Germany – cannot ignore these linkages, lest they want to forfeit their most potent tool – their commercial might. They need to use it to advance their overall interests, not just their commercial interests.

Third, Europe and the U.S. will likely enjoy a period of unusually strong domestic demand in 2022 and 2023 as the pandemic turns endemic. During lockdowns, consumers have built up huge excess savings equivalent to 19% of their 2019 consumption in the US and 13% in the Eurozone. They are eager to spend some of this money. As a result, the US and Europe need exports to China to raise their aggregate demand less than usual.

What it means for China to act as a responsible global player

China often seeks to position itself as a responsible global player. Such assertions, however, must be based on actually accepting and following global rules. They are not a function of rhetorical claims, big-event speeches or the size of a country's economy or population. Standing as a responsible global player must be earned. It cannot just be stated self-servingly as a fact.

In practice, China under Xi Jinping only seems to follow rules and generally accepted norms of behavior as it sees fit. China often signals severe displeasure whenever any country, company or even sports stars speak up for human rights in China. Just ask Australia and Lithuania. The Chinese then threaten to take punitive commercial or other action unless the other side bows down.

Not standing up to China on such occasions creates precedents which, in turn, makes it more difficult to take a more principled stance in the future.

At the present moment as well as over the medium and long term, the EU – and much of the world – have an abiding interest in a China that plays by the rules. Quite naturally, the stronger nations and closer economic partners of China must lead by example. That puts Germany into the lead within Europe.

Unless Germany accepts its leadership role in that regard, it would be futile to hope for weaker countries to hold China to global rules and standards of cooperation, openness, fairness and respect for human rights.

The more policy makers in Germany and the EU co-ordinate their approach with the Biden administration in the United States, the more confident can they be that they have powerful tools to influence Chinese policymaking across a range of issues because of China's commercial dependence on relations with its major overseas markets.

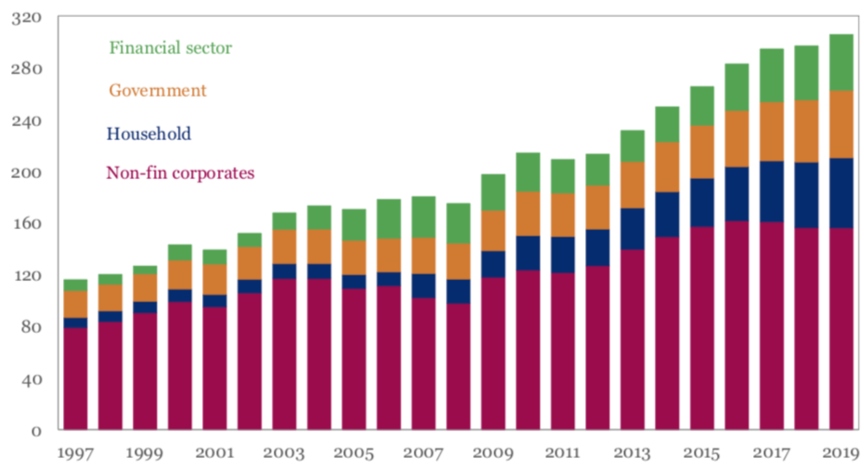
"China is more vulnerable than its headline economic statistics may suggest. Much of China's impressive GDP growth is based on a succession of domestic credit-fueled spending binges."

China is more vulnerable than its headline economic statistics may suggest.

Much of China's impressive GDP growth is based on a succession of domestic credit-fueled spending binges, often in the form of public investment with diminishing returns. The results are domestic economic and financial imbalances which could be potentially dangerous.

As a result, China's total debt ratio of more than 300% of GDP – see Chart 5 – is extremely high for a country at its stage of development. Of course, China can afford that debt – and the ongoing surge in its debt ratio - in the sense that its debt is internal. China does not depend on the goodwill – or the disciplining force – of external creditors.

Chart 5: China debt to GDP ratio



Q2 data. Source: Institute of International Finance

"The prospect of reduced access to major foreign markets would be highly unwelcome for China as it would likely translate into job losses in its manufacturing plants."

However, because the debt seems to at least partly fund projects of limited commercial viability, China will face the political problem of how to allocate the losses from such unprofitable projects all by itself and within its own borders. The potential economic fallout will eventually need to be distributed between savers and investors, taxpayers, businesses and workers in China itself.

"The willingness of Europeans and Americans to give China major leeway just because it has long been the low-cost producer is running out."

The desire to avoid or at least postpone such a reckoning with hard-to-predict domestic effects makes it even more imperative for China to safeguard its economic performance. Weakening its economic outlook by risking serious trade conflicts with its major trading partners is bound to exacerbate China's long-term problems. Inter- and intra-company lending by state-owned enterprises (SOEs), a banking system that is guided by government policy priorities rather than by prudent lending practices and is overseen by party-chosen regulators and supervisors create a dangerous mix.

To make matters worse, China's de facto takeover of the Special Administrative Region (SAR) of Hong Kong is not only politically an own goal. China has so far benefited from the independent, internationally recognized, rule-based financial center of Hong Kong.

By undermining the independence and international reputation of one of its key gateways to global financial markets, China is casting a shadow over its own financial future.

In addition the prospect of reduced access to major foreign markets would be highly unwelcome for China as it would likely translate into job losses in its manufacturing plants.

At the same time, the willingness of Europeans and Americans to give China major leeway just because it has long been the low-cost producer is running out. When China was poor and its economy was much smaller, advanced countries happily granted China special emerging markets privileges, to some extent for humanitarian reasons.

Now that China has moved up the ladder and it is throwing its commercial and political weight around, the rationale for such privileges has gone. The advanced world is bound to demand that China grants full reciprocity, allowing Western companies and investors access to its market under the same terms that China can access the markets of the Western world.

"The biggest risk for the Chinese leadership is this: A serious parallel deterioration in China's trade relations with the United States and the EU could strain the Chinese leadership's implicit deal its population as a guarantor of maximum employment and steady."

With the "Comprehensive Agreement on Investment" (CAI) which the EU concluded with China at the end of 2020, the EU – acting very much at German Chancellor Angela Merkel's prompt – took a step in this direction. Arguably, the EU might have achieved even more if it had waited a little longer and coordinated its approach with the Biden administration which took office less than a month after the EU and China signed the yet-to-be-ratified deal.

However, recent events have led the EU to shelve that CAI for the foreseeable future. At least the European Parliament will likely insist on full reciprocity before it is willing to pass the agreement at any future date. Europe is starting to learn the lesson.

The Japanese precedent

The experience of its neighbor Japan carries lessons for China. During the first four decades after World War II, Japan advanced arduously to become one of the largest economies in the world. Its strategy was initially based on serving as a low-cost producer for the United States and Europe. But once Japan's goods production had moved up the value-added chain, the United States and Europe changed their accommodat¬ing position to the Japanese export machine.

Europe and the United States demanded reciprocity, which Japan was reluctant to grant for a long time. The tougher line of the U.S. and Europe toward Japan added to the problems of the country in the wake of its 1990s financial crisis. Today, high debt levels and an ageing population hold back Japan.

"China might be inclined to retaliate tit-for-tat if Europe were to constrain Chinese access to its market in a dispute. But it would not be in China's economic interest to go very far."

China's leaders, as much as they would like to ignore that parallel, certainly know that, in terms of debt and demographics, their country is heading in the same direction – except that Japan is a very rich country, while China is still fairly poor.

China under internal and external pressure

Perhaps the biggest risk for the Chinese leadership is this: A serious parallel deterioration in China's trade relations with the United States and the EU could strain the Chinese leadership's implicit deal with its population as a guarantor of maximum employment and steady gains in living standards.

This reality, which is also understood by China's leadership as forming the core of their preserving their political power and legitimacy, constrains the country's ability to use economic tools to put pressure on other countries.

In a pure trade policy context, China might be inclined to retaliate tit-for-tat if Europe were to constrain Chinese access to its market in a dispute. But it would not be in China's economic interest to go very far in that direction.

"It is not in China's interest to further strengthen the tendency of manufacturers outside China to diversify their supply chains away from China."

If the EU, applying the reciprocity principle far more straightforwardly, were to scrutinize Chinese investments into Europe much more diligently and imposes sanctions on Chinese officials and business leaders involved in Chinese misbehavior, China would probably react. But if China knows that the EU would then counteract Chinese measures to restrict EU access to the Chinese market like-for-like, the Chinese leadership – in its well understood self-interest – would have strong economic reasons to restrain the scale of its response to pressure from the EU.

In the U.S.-China trade war of 2019, China imposed fewer punitive tariffs on its imports from the United States than the U.S. had levied on imports from China. This partly reflects the trade imbalance, with China importing far fewer goods from the United States than vice versa. However, China also refrained from fully using its potential leverage over other U.S. interests on the Chinese market. In a way, China sought to de-escalate somewhat, instead of responding by fully playing tit-for-tat.

The domestic repercussions from a worsening trade conflict with the United States may have been one reason for that. It is not in China's interest to further strengthen the tendency of manufacturers outside China to diversify their supply chains away from China.

Of course, China may respond to joint U.S.-EU pressure in ways that would hurt for a while. For example, China is the top supplier of rare earths, a key ingredient for many digital devices. However, even on this crucial issue where China seems to be holding all the cards, locking or restricting rare earths exports would be self-defeating for China after a while.

History has shown time and again that an artificially created shortage of raw materials spurns major and usually successful searches for alternative sources of these materials, or for alternative materials. And once major users have managed to diversify away from rare earths produced by China, China will have lost much of the market for good.

The rationale for Chinese rulers to use the threat of withholding exports of special products to the EU and the US to put pressure on them is even weaker. Even if some Chinese companies have moved to the technological frontier, for instance in 5G technologies, the United States and Europe could afford to develop their own competitors.

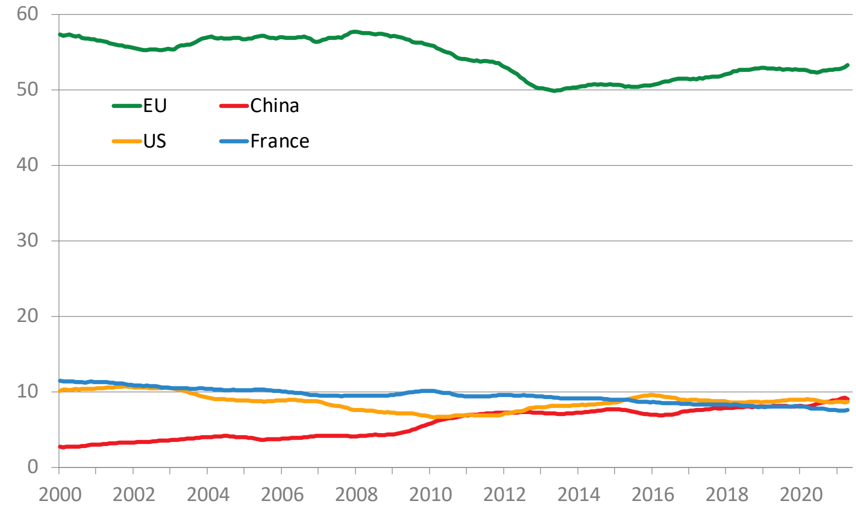
For example, a potential modest slowing down of the pace of 5G rollout would be acceptable. Because of inherent security concerns, the EU may well follow the U.S. lead anyway in reducing the need for Chinese high-tech inputs anyway. For other goods, Western importers could probably find substitutes for supplies from China easily at little extra cost after a brief transition period. After all, China itself is no longer the low-cost producer it used to be.

The potential fallout on the German economy

What would be the potential economic fallout on the German economy if the German government decided to adopt a tougher stance toward China and nudge the European Union in that direction? Trade policy, after all, is the prerogative of the EU.

China is a major trading partner for Germany, as was shown in Chart 1 above. If China were to respond to pressure by restricting access to its markets, Germany and/or the EU would pay a price. But let us look at the data presented in Chart 1 in a different way: Relative to the exports that Germany sells to other European Union countries, Germany's dependence on China remains modest – see Chart 6.

Chart 6: Share in German goods exports, in %



12-month rolling averages. Source: Destatis

"What matters for the German economy is less the fate of global car companies that are headquartered in Germany."

The impact may be significant for some sectors, such as the German car industry, that have become heavily dependent on the Chinese market for their sales and for their profits. The major German car manufactures sell some 35-40% of the cars they produce in China. The country may account for similar or slightly higher share of their profits. The same holds for some other companies such as Germany's leading producers of semi-conductors.

Dont´t focus on the car companies

"The fact that German corporations earned good money in their China business in the past is no indication that this will be true to the same extent going forward."

However, what matters for the German economy is less the fate of global car companies that are headquartered in Germany. The profits these companies earn from employing Chinese workers to build cars in China with inputs from China to sell to Chinese customers play no major role for the German economy itself. They matter only in modest ways, primarily in that the incomes which the companies derive from these sales help to pay salaries at corporate headquarters in Germany and the dividends to those of their stockholders who reside and pay taxes in Germany.

What matters for the German economy is the value added generated in Germany, i.e., the German content of German cars sold in China. This would likely be affected by Chinese measures against German car companies, but much less so than the mere look at reduced sales of German-branded cars in China would suggest.

In addition, the fact that German corporations earned good money in their China business in the past is no indication that this will be true to the same extent going forward, especially considering that the Chinese leadership has made an explicit decision to strive for technology leadership in many fields. Some Chinese firms are morphing from good customers to hard competitors.

Of course, Germany is vulnerable to tensions between Europe and China. Germany depends more on exports to China and other non-EU members than most other countries in Europe.

However, this argument is less far-reaching than it appears at first glance. It overlooks that the hallmark of the German economy and its manufacturing sector is its resilience to shocks. Used to decades of sudden and sharp appreciations in the exchange rate and other shocks, Germany's Mittelstand in particular has developed a level of resilience and an ability to adjust that is almost unsurpassed in the advanced world. The German economy – at the heart of which are the Mittelstand companies – could stomach a more restricted access to the Chinese market.

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This study is part of the "Germany in Europe" project by the Global Ideas Center in Berlin, which is funded by Stiftung Mercator.

About the Global Ideas Center (GIC)

The Global Ideas Center (GIC) is a non-profit, independent and virtual think tank. It works with a global network of practitioners and civil society actors to feature their insights into critical issues of national and international concern in a solutions- and reform-oriented manner.

The analysis provided by the Global Ideas Center often involve cross-border comparisons. The principal purpose is (1) to contribute to improving/optimizing relations between countries and (2) to highlight lessons to be considered and potentially learned from other countries for domestic implementation.

The mission of the Global Ideas Center is to act as a catalyst to help solve real problems which countries and societies face via "The Power of Comparisons". The GIC tackles powerful interests and conventional wisdom to drive an open, honest, educated and results-oriented debate.

About the Strategic Intervention Papers (SIPs)

The aim of our "Strategic Intervention Papers" (SIPs) is to address a specific challenge existing in a nation and to trigger public debate on this issue in order to bring it to a constructive solution.

About our "Germany in Europe" project

The first project of the Global Ideas Center (GIC) primarily explores perspectives and ideas from its European partners that can help Germany solve its own political problems. The project is funded by Stiftung Mercator.

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About the author

Holger Schmieding is Chief Economist at Berenberg in Hamburg and London. Before joining Germany's oldest private bank in October 2010, he worked as Chief Economist Europe at Merrill Lynch, Bank of America and at Bank of America-Merrill Lynch in London.

After studying economics in Munich, London and Kiel, he completed his doctorate at the University of Kiel. Before taking up his first role as financial market economist in 1993, he worked as head of a research group on east-central Europe at the Kiel Institute of World Economics and as a desk economist at the International Monetary Fund in Washington, D.C.

In 1992, Mr. Schmieding co-authored the book "The Fading Miracle" on Germany's post-war economic history in 1992 and in 2014, he published a book on the Euro "Unser gutes Geld – warum wir den Euro brauchen".

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Conclusions:

Germany: Not China's Economic Pawn

1. Over time, soft power matters. China has come to realize this. But its efforts to build up and wield soft power remain clumsy. With their behavior vis-à-vis Hong Kong, Taiwan, Tibet or the Uighurs, China's leaders all too often tarnish their global image visibly. Their harsh reaction to criticism only adds to that.

2. Occupying the moral high ground based on principle is in the long-run interest of Germany, Europe and of much of the world. **If a strong and successful economy such as Germany cannot stand up to the Chinese, the prospects for achieving global balance are dimmed.**

3. European societies should feel encouraged by the fact that they are free and comparatively rich. Moreover, despite serious internal strains, they offer better social protection to their citizens than most other countries. It is in the interest of Europe that people elsewhere measure their own rulers against standards de facto set by Europe and the US.

4. Europe does not have the military might to impress China or Russia. As a result, Germany and Europe have to put even more weight on the key tool they have at their disposal, their economic clout as a technology provider and as a key market for the exports of others.

5. Of course, Germany and Europe must focus their efforts. They cannot use their economic might to go against all grave injustices perpetrated by China and others.

6. For Germany and the EU, holding up rules, supporting multilateral institutions and ensuring the free flow of goods over the seas and oceans of the world is not just a nice figure of speech. It is an essential strategic interest. In Hong Kong, for example, China has violated an international treaty which it had concluded itself. That justifies and requires a clear if measured response.

7. Likewise, Chinese refusal to accept maritime law, the conversion of occupied reefs in the South China sea into military outposts and the threats against Taiwan should also be a concern for Europe which needs the freedom of the seas for its trade.

8. The EU should insist on strict reciprocity in its economic relations with China. **If China denies certain privileges to European companies and investors, Chinese investors should not be able to enjoy these privileges in the European market.**

9. Germany itself can afford to take a more principled stance toward Beijing.

10. This approach would not be without costs. But using the EU's economic clout to uphold rules and stand up for its core principles when and where it truly matters will ultimately benefit Europe. Accepting Chinese breaches of rules without an adequate response, and thus encouraging China – and others – to go further, would ultimately be much more costly for Germany and Europe.