Germany's China Dilemma

By Klaus C. Engelen

And the "America First" challenge.

At a recent weekend, the leaders of the present German coalition government, still headed by Chancellor Angela Merkel, gathered in Berlin to discuss why they have lost millions of voters in recent elections. Merkel's party union is still struggling with the refugee open border disaster, while the Social Democrats proposed a fundamental overhaul of Germany's social state, dumping the Hartz IV welfare reforms of 2003–2005.

IS THE GERMAN MODEL BROKEN?

While both German governing parties were making headlines by acknowledging their past mistakes in a world that has lost its decades-old foundations, there came a wakeup call from the editors of *The Economist.* Looking at the challenges faced by industrial powerhouse Germany in the real world of global trade and finance, the magazine's cover asked a provocative question: Is the German model broken?

Inside, the British magazine warns that for Germany's economy it is "time to worry," and that "an economic golden age in Germany could be coming to an end," and that "the German economy suddenly looks vulnerable."

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America First

Since President Donald Trump began claiming "America First," there have been the shocks and disruptions caused by the dramatic policy shifts of the United States as the world's largest economy. The Americans who built the global multilateral system after World War II with institutions like the International Monetary Fund, the World Bank, and the World Trading Organization have suddenly turned against a global trading and investment order that created unforeseen prosperity for countries and people, and also for the United States.

—K. Engelen

ALI SHAKER; VOICE OF AMERICA

Beyond the short-term slowdown, *The Economist* sees "the changing patterns of trade and technology moving against Germany's world-beating manufacturers." Weakness in part "reflects the fallout from the trade war between China and America, two of Germany's biggest trading partners. Both are increasingly keen on bringing supply chains home. America is due soon to decide whether to raise tariffs on European cars. Trade is already becoming more regionalized as uncertainty grows. If global commerce splits into separate trading and regulatory blocs, Germany will find it harder to sell its goods to customers around the world."

The European stock market—with the thirty German DAX shares falling 18.26 percent in 2018—reflects the deepening economic, political, and strategic uncertainties. In all directions, Germany is facing darkening clouds on the horizon.

German Chancellor Merkel warned of "a disintegration of international political structures."

There is the expected economic downturn in Germany and Europe. Since President Donald Trump began claiming "America First," there have been the shocks and disruptions caused by the dramatic policy shifts of the United States as the world's largest economy. The Americans who built the global multilateral system after World War II with institutions like the International Monetary Fund, the World Bank, and the World Trading Organization have suddenly turned against a global trading and investment order that created unforeseen prosperity for countries and people, and also for the United States.

There is the danger of severe economic damage should a no-deal Brexit for the United Kingdom become a reality. Both the United Kingdom and the EU member countries could see massive job losses. After all, the United Kingdom is the third-largest European economy and Europe's leading financial center. Among EU member states, there is a dramatic worsening of the political climate and a fracturing of cohesion. The rise of populists and anti-EU nationalists in some member countries will have alarming political implications in the coming European elections.

There is the specter of the European Union falling into a trap of low economic growth with high unemployment due to the lack of needed common-sense economic policies with structural reforms and taking account of high debt levels. Anti-EU governments such as Italy are undermining the legal foundations on which the European Union operates. With its mountain of debt, Italy's problems are big enough to threaten monetary union.

With the shocks and disruptions since Trump became president—questioning the NATO alliance and starting an economic war with Europe—the postwar transatlantic foundations for western democracies are coming down. Under an increasingly imperious Vladimir Putin, Russia has returned as the big political and military threat on Europe's eastern borders. The annexation of Crimea happened in disregard of the treaties that were signed to end the Cold War. As the *Washington Post* warned on the eve of the U.S. president's last State of the Union speech: "Europeans fear Trump may threaten not just the transatlantic bond, but the state of their union."

As *Deutsche Welle* reported from the Munich Security Conference, German Chancellor Merkel warned of "a disintegration of international political structures." International structures to maintain security were under pressure to meet the demands of a changing world. "What we see as an overall architecture underpinning our world as we know it is a bit of a puzzle now; if you like, it has collapsed into many tiny parts." Noting a deterioration in relations with Russia, she said: "We have to think of integrated structures and interdependencies." Merkel directed several specifics in her speech at the United States, questioning the wisdom of a rapid U.S. withdrawal from Syria and Afghanistan, and the notion that "German car exports represented a threat to U.S. national security," stressing that, for instance, BMW's largest plant is in the United States, not in Bavaria.

Trump is using the dollar as a weapon.

A U.S. SHOWCASE OF ECONOMIC IMPERIALISM

For the European Union—and especially for Germany as its largest exporter—its stake in the United States as the largest trading and investment partner is threatened under Trump's "America First" policy.

As the leading German magazine *Der Spiegel* concluded in June of last year in a major analysis on "Economic Trumpism," "Seldom has an American president exploited the country's economic power to the degree the Trump administration has. Washington appears to be attacking German companies at every opportunity." The magazine starts by quoting Trump saying "he no longer wants to see the sight of a Mercedes on Fifth Avenue in New York."

Some of the magazine's findings: Trump is using the dollar as a weapon. Insiders at the Bundesbank and the German finance ministry assume, for instance, that a crisis report on Deutsche Bank was leaked by U.S. authorities. Critical insiders are asking why car

China's German Investment

"From the peak in 2016 with forty-four takeovers and investments in stakes in companies from China," says Christian Rusche, economist of the German Economic Institute (IW), who follows China's direct investments in Germany, "we saw forty transactions in 2017 and thirty-three transactions last year. In the years 2010 to 2015, the average yearly number of transactions was twenty-two."

Rusche points out that in 2017 and 2018, the German government sharpened its Foreign Trade Ordinance to the effect that in sensitive areas, the German authorities can decree special examinations of foreign investments amounting to more than 10 percent of a German firm's capital. Last year, says Rusche, the German government blocked Chinese investors from taking stakes in two German firms, Grid Corporation and Leifeld Metal Spinning.

In his regular monitoring briefing, Rusche puts the publicly available total value in 2018 for fifteen transactions by Chinese investors at nearly €9 billion, for fifteen investments in 2017 at €12.1 billion, and twenty-five investments in 2016 at €11.1 billion. Looking at these numbers, one has to take into account that only 45 percent of the transaction value in 2018, 38 percent in 2017, and 57 percent in 2016 was reported. The largest Chinese industrial investment was Li Shufu of the Geely Group paying €7 billion for a 9.7 percent share in Daimler.

In February 2017, China's biggest aviation, logistics, and services conglomerate, HNA, started taking stakes in Deutsche Bank in a complicated set of investments that reached a peak of close to 10 percent. The HNA stake was later reduced to 7.6 percent. In September of last year, there were reports that HNA would get out of its Deutsche Bank investment under pressure to reduce the conglomerate's high debt.

—K. Engelen

Weaponizing the Driving Machine

At the 2019 Munich Security Conference, German Chancellor Merkel warned, "What we see as an overall architecture underpinning our world as we know it is a bit of a puzzle now; if you like, it has collapsed into many tiny parts." She questioned the notion that "German car exports represented a threat to U.S. national security," stressing that, for instance, BMW's largest plant is in the United States, not in Bavaria.

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German Chancellor **Angela Merkel** *addresses the 2019 Munich Security Conference.*

companies with deeper roots in the United States that are believed to have manipulated emission readings were not hit with fines as was Volkswagen. The German magazine considers the Trump administration's blockbuster campaign against the Russian natural gas pipeline Nord Stream 2 as a "showcase of economic imperialism." There, as in the case of the Trump administration's sudden exit from the Iran nuclear deal, the U.S. administration is using "diplomatic pressure, intimidation and sanctions."

But there is a mega-problem that Europe shares with the United States as the world's largest economies, and that Trump blatantly addressed in his State of the Union speech in Early February: "We are now making it clear to China that after years of targeting our industries and stealing our intellectual property, the theft of American jobs and wealth has come to an end. …We are now working on a new trade deal with China. But it must include real, structural change to end unfair trade practices, reduce our chronic trade deficit, and protect American workers."

WHEN GERMANS GET WORRIED ABOUT CHINA

In Germany there is increasing anxiety about China's worldwide economic and geopolitical aspirations. Germans are realizing that China's Communist leaders in the recent decade—while conquering the world with ever more trade, investments, and loans—are deepening the internal suppression of their people through grave human rights abuses.

Yet, when visiting Duisburg in the center of Germany's bygone industrial heartland, one hears admiration and relief about China's decision to develop the Duisburg-Rheinhausen Krupp site into one of the largest container ports in Europe.

In 2014, when China's President and Communist Party boss Xi Jinping came to a state visit to Germany, he insisted on also visiting the Duisburg inland port which he considers an important stop on the New Silk Road.

About twenty-five trains arrive each week at the "China terminal." They come mostly from Chongqing across Kazakhstan, Russia, Belarus, and Poland, covering a distance of more than 11,000 kilometers in about three weeks. Each train is about 600 meters long and transports about forty containers. Twice the containers have to be reloaded to adjust to the different rail systems on the way. It was not surprising that this trade route—ending in Duisburg—that brings China and Germany together as beach-head for European markets was welcomed on the German side. A lot of new jobs were created locally.

But some have been looking more skeptically at Xi Jinping's grand strategy, including Theresa Fallon from the Centre for Russia Europe Asia Studies in Brussels. Fallon argues that "when Xi Jinping first launched the Belt and Road Initiative, the idea of improving trade and transport links between China, Asia, and Europe was received favorably in many European countries."

Continued on page 81

Continued from page 63

Central and south-eastern European governments were especially keen on Chinese infrastructure investments. But "five years on, the mood has somewhat changed. There are concerns over 'debt diplomacy' and political influencing. And there's pushback from Brussels," warns Fallon. She asks how to engage with China without compromising European standards and values.

In other regions where China is using oceans and seaports for its own strategic aims, such as with its Maritime Silk Road strategy, Beijing's ambitious masters of the universe are causing unease from India to the United States.

Pressure to exclude Huawei and other Chinese 5G high-speed network suppliers such as ZTE has been building.

China is not only a huge commercial opportunity but also a threat. Stealing technological know-how in key industrial sectors became a bone of contention in Germany when, in May 2016, the Chinese group Midea announced its intention to take over KUKA, a global leader in industrial robotics, for a price of €4.6 billion. In media reports from that time, the deal was seen as a wake-up call for economic policymakers. German EU Commissioner Günther Oettinger warned that KUKA should not fall into Chinese control. And Sigmar Gabriel, Germany's economic minister at the time, was so much concerned that he urged German multinationals such as Siemens and Bosch to bid for the country's leading robotics manufacturer.

Hubert Lienhard, the former CEO of Voith who headed the prestigious Asia-Pacific Committee of German Business (APA) for the past five years, and who will pass this position to Siemens chief executive Joe Kaeser, a few days ago admitted to the *Frankfurter Allgemeine Zeitung* that his goal was to reach equal treatment by Chinese authorities towards foreign companies. Looking back at his tenure, he concluded: "This is not the case. Never could a western company in China take over a robotics manufacturer or buy a high-speed telecommunication network. If the European Investment Bank opens biddings, it does not require quotas for domestic products. In China this would be the case." In his five years as APA head, Lienhard has witnessed the rise of President Xi Jinping and China's development into a repressive regime. "We all thought that in the medium term China would more and more adopt a western market economy. To stick to this hope is increasingly difficult. We experience a competition of systems."

The takeover of KUKA went through. As it turned out, as a Midea subsidiary, KUKA had to report a lot of bad news, notes *Handelsblatt.* "Twice the firm had to lower its earnings forecast. Since the fall of 2017, its share price fell by three-quarters. Its boss Till Reuter left the company. The new owner arrived with a big promise of major investments that did not become reality. Now the firm faces an austerity program."

In May of last year, the editors of *Der Spiegel* came out with longer piece titled, "Economic Superpower: Chinese Expansion Has Germany on the Defensive," looking at what happened to KUKA. Asking KUKA's union leader Armin Kolb, they got an upbeat answer: "We got the best deal we possibly could," reporting, "Midea has committed to retaining the company headquarters, and refraining from moving or closing factories to preserve jobs. The agreement is valid until 2023."

Since the KUKA takeover, the question of whether Chinese investors in Germany will turn out to be an opportunity or a threat remains open. "The German economy has grown dependent on China in a development that is now coming back to haunt it. With a global trade war brewing, it will be impossible for the government in Berlin to please both Beijing and Washington. It's time for a new strategy," warned the magazine.

But according to the German Economic Institute, an organization that monitors direct investment activities from China in the German economy, investors from the People's Republic are getting more cautious in terms of takeovers or stakes in German firms.

GERMANY'S INDUSTRY ASSOCIATION ATTACKS CHINA

Another turning point in terms of standing against China's trade and investment threats happened in January 2019, when Germany's Federation of German Industries (BDI) presented its tough policy paper on China, "Partner and systemic competitor: How do we deal with China's state-controlled economy?"

"The People's Republic is establishing its own political, economic, and social model," said BDI president Dieter Kempf. Policymakers can no longer afford to "simply ignore the challenges China poses to the

European Union and Germany." And he continued, "It is in Beijing's own interest to open up its domestic market further and to vigorously implement long-announced economic reforms." And as a wake-up call in the direction of Brussels, BDI calls for a "strengthened economic policy framework for the European single market. This should ensure that companies from non-market economy countries are bound to the liberal market economy regulations of the EU if they want to be active in Europe."

"China's state-dominated economic system conflicts in many respects with the liberal and social market economy principles in the EU and many other countries," argues BDI. "While in Europe the market is the central organizing principle of the economy, China seems to regard market mechanisms as means that can be applied selectively."

For some, the BDI strategy paper was too harsh. As Reuters reported at the time, economist Volker Treier of the Association of German Chambers of Commerce and Industry (DIHK) argued that "the BDI position paper on China brings another tone into the debate. But we always have to keep in mind that China is our most important trading partner. So every word should be weighed carefully." The DIHK estimates that some 900,000 jobs in Germany depend on exports to China.

As the BDI paper stresses, China is of great importance for German industry. Family businesses, small- and medium-sized enterprises, and listed companies have benefited from China's enormous economic rise and continue to do so. In 2016, German direct investment in China amounted to around €76 billion or 6.8 percent of total German foreign investment. Approximately 5,200 German companies comprising over one million employees were active in China. Due to the strongly integrated value creation networks and the current position of German industry in the Chinese market as well as the potential business in China, an economic disengagement from China would entail enormous costs. German industry rejects this and is concerned that such a measure is increasingly being discussed in the United States.

The question of whether Chinese investors in Germany will turn out to be an opportunity or a threat remains open.

The Social Democrats proposed a fundamental overhaul of Germany's social state.

CHINA: A TRAP FOR GERMANY'S MULTINATIONALS?

What was not much explored in the BDI strategy paper was the alarming dependence of leading German companies on the Chinese market. *Handelsblatt,* Germany's leading business and financial daily, took on the complicated task of measuring the dimensions of Germany's economic dependence on the huge Chinese market.

The editors of *Handelsblatt Today*—in English—headlined "Red Scare—German firms facing perfect storm as Chinese growth slackens." The piece posed a pertinent question: "In recent years, German economic success has become increasingly dependent on exports to China. With a trade war looming and the Chinese economy showing signs of trouble, could Germany be sucked under too?"

China's economy slowed to 6.6 percent annual GDP growth in 2018—high by world standards but the lowest in almost three decades. This is causing anxiety. Also last year, Chinese car sales went down for the first time in two decades.

Handelsblatt Today looks back twenty years and concludes, "When China slows down, Germany will take a particularly painful hit. Twenty years ago, China was not important to the German economy. Back then, German exports to the People's Republic amounted to just €5.4 billion ($6.2 billion). By 2007, that figure was €30 billion. Last year it was €90 billion, almost 3 percent of German GDP."

One mindboggling statistic from the *Handelsblatt Today* report shows how German firms would face the perfect storm as Chinese growth slackens. Overall, for the thirty companies that make up the DAX blue chips index—firms that operate about seven hundred subsidiaries in the People's Republic—the Chinese market represents an average 15 percent of revenues, totaling around €200 billion.

"For car makers BMW, Daimler, and Volkswagen, semiconductor manufacturer Infineon and the specialist chemicals maker Covestro, the proportion is strikingly high," reports *Handelsblatt Today.* "All five companies earn over 20 percent of their annual revenues in China, more than in the German market. Therefore, estimates of future German corporate earnings rely heavily on continued Chinese growth. If that market falters, it could mean sleepless nights for many executives and investors, with the recent slump in Apple's stock market valuation pointing the way. When Apple's share price fell heavily on news of the slowing Chinese economy, the price of Infineon stock fell with it."

Already, German carmakers have been doubly hit by the U.S.-China trade dispute: both falling car sales in China and tariffs being slapped on cars they produce in the United States for export to China. BMW and Daimler are already warning of an impact on sales and profit margins.

Handelsblatt Today zooms in on the German company under the biggest threat, Volkswagen. "No other carmaker has tied its fortunes to the Chinese market to quite the same degree as VW. In 2018, the company's twelve brands sold more than three million vehicles in China, compared to just 1.3 million in Germany."

BERLIN'S HUAWEI HEADACHE

Since German political leaders are aware of the dimensions of the country's economic dependence on the Chinese market, they need to be very circumspect as they decide on Huawei's role as supplier of telecom equipment as phone companies start building their high-speed 5G networks in Germany.

Huawei's latest generation high-speed technology is cheap and innovative, argue industry experts in the telecommunications industry. Banning Huawei from supplying 5G networks in Europe, even from just the sensitive core networks, would significantly delay construction and add massively to costs, reports *Handelsblatt.* The paper learned from government sources that Berlin might stop short of an outright ban on Chinese telecommunications technology but introduce new security rules under a revised German Telecommunications Law. Under a new legal framework, Germany's Federal Network Agency and the Federal Office for Information Security would be empowered to apply continuously much tougher security standards. As *Handelsblatt* reports, "Both agencies will draft rules that would force any telecom company to have its equipment certified and disclose the source of the codes operating the gear. This would allow regulators to discover so-called backdoors and detect and monitor otherwise encrypted data flows."

China is of great importance for German industry.

As Patrick Sensburg, a key security legislator of Merkel's CDU party, argued in an interview with *Deutschlandfunk,* "The spying risks in telecommunication equipment and networks are there, but not only in Chinese technology. We should not forget the Patriot Act in the case of America. If we were to install Cisco routers, security would not be 100 percent."

Pressure to exclude Huawei and other Chinese 5G high-speed network suppliers such as ZTE has been building after a number of countries—from the United States to Australia and New Zealand—formally banned Huawei as the largest and most innovative supplier.

German Chancellor Merkel is following a "softly, softly" line. While visiting Japan, she called for better assurances on security from Huawei and the Chinese government. Merkel was referring to how, under Chinese law, its authorities could require all the countries' companies to supply information they have access to. When dealing with the difficult Huawei issue, the Brussels authorities also come into the picture. Companies in the telecom industry may be facing even more security and transparency requirements coming from the European Union, according to diplomatic sources.

A STRATEGY TO GET BACK MORE SOVEREIGNTY

Germany's increasing economic dependence on China, as well as America's ravaging economic imperialism directed at the highly regulated European Union industrial powerhouse Germany, are forcing Berlin's key policymakers to fight back and respond to the new alarming economic and political threats to Germany's prosperity and political stability.

"Germany has a strong and successful industrial base. We need to keep it that way, and we need to expand it," said Peter Altmaier, German economic minister, when he presented the draft of a new "National Industrial Strategy 2030" in February 2019.

In his strategy paper, he pointed to the limited power of free markets to counter the growing might of mega-corporations abroad. The paper outlines policies to enable Germany to hold its own against growing foreign competition at a time when the economy is slowing down.

Altmaier wants to explain his proposals first to the German public and then discuss them on the EU stage. In the wake of the EU Commission blocking the Siemens-Alstom mega-merger of their rail businesses, Altmaier's demand for "a rethink of EU antitrust regulations and the creation of heavyweight business 'champions' to rival those in the United States and China" are controversial to some and timely to others. "Industrial policy strategies are experiencing a renaissance in many parts of the world. There is hardly a successful country that relies exclusively and without exception on market forces to cope with its tasks."

"Germany enters the global economic wars," was the reaction of Bloomberg's Berlin correspondent Leonid Bershidsky. "With the U.S. and China increasingly competing rather than cooperating, Europe can't stick to the old concept of globalization. … In this struggle for dominance, Europe—and Germany in particular—is being relegated to the status of passive observer." ◆

German firms would face the perfect storm as Chinese growth slackens.