## Germany - China Investment – Opening doors?

Germany and China increased their trade to 170 billion Euros last year, defying downward pressure in China and many other countries. German investment in China, as of now, remained steady, bucking the trend of significantly slowing investment in China from the rest of Europe. Chinese investment in Germany in 2016 increased dramatically and focused on buying German tech companies. 90% of German investment in China again focused on greenfield investments. How we can further strengthen the already flourishing comprehensive strategic partnership between Germany and China will be an important topic when Premier Li Keqiang will visit Berlin next week. The visit by President Xi Jinping to Germany in July will crown the efforts of our two countries to move closer together in these uncertain times. Our relationship has moved far beyond the economic sphere. However, a flourishing and open economic relationship remains its foundation.

Openness for investment is moving more and more towards the centre of our economic relationship with China. There are many reasons. We have seen that investment flows have a direct impact on trade flows, with global value chains becoming more and more complex. Another main factor is competitiveness in the high-tech sector. Acquisitions of high-tech firms are an important strategy to enhance competitiveness of single companies and, possibly, entire economies. Another reason is the head-spinning pace of developments: In 2016, the value of China's takeovers of German companies increased twentyfold over the previous year. Some have claimed that German investment stocks in China are so huge (around 60 billion Euros) that concerns expressed at a sudden wave of takeovers of prime robotics company Kuka and other high-tech companies where overblown, some even pointed to a protectionist trend in Germany. This is not convincing. Not a single transaction has been blocked by German authorities. At the current rate, Chinese investment stocks in Germany could outstrip German stocks in China within three to five years. This is becoming more and more likely. Acquisitions in the first four months in 2017 were valued at over 3.5 billion USD, their pace is almost exactly the same as in 2016, which saw acquisitions of well over 10 billion USD.

The volumes themselves are not the problem. The problem is the lack of a level playing field. Chinese companies take advantage of one of the most open investment markets in the world. However, if one looks at the important sectors of the Chinese economy, one invariably arrives at the same conclusion: Investment restrictions have not been lifted, and in important areas, the level of restrictions has even increased.

### - Services: Most important areas closed in China

The service sector is by now the largest sector of the Chinese economy, its GDP share has moved beyond 51%. For Germany, which is mostly known as a manufacturing powerhouse, trade and investment in services is actually of fundamental importance to its prosperity. Germany exports more than 250 billion USD worth of services, far more than even its car industry.

Unfortunately, China keeps the most lucrative parts of its service sector tightly shut. Telecommunications, the media, large parts of domestic logistics such as postal and related services, are almost completely closed and therefore protected from foreign competition. There are few concrete signs that this will change. In banking and insurance, foreign

businesses are marginalized completely. The market share of foreign banks has dropped to just above 1% and in insurance, market share of Chinese insurers has increased to around 94%. This low level of foreign participation is almost unique to China. Legal investment hurdles are high and have hardly changed over almost forty years. Insurance companies are forced to enter joint ventures as minority partners. Foreign single investors are not allowed to acquire more than 20% of a Chinese bank. Foreign banks and insurance companies need individual licenses for every branch and sub-branch in each province. Acquisitions of stakes in banks even below the legal thresholds are subject to approvals by a multitude of authorities and can be withheld without reason and in most cases without legal recourse. This tight control of the acquisition of any stake in a Chinese company by foreigners is not limited to banks, it is a general characteristic of the Chinese investment framework and one of the reasons why the Chinese bureaucracy responsible for investment is so huge.

Once banks and insurances have cleared all these hurdles, their scope of business is severely limited in comparison to Chinese competitors. The OECD estimates that service sector restrictions to foreign competition can impose the equivalent of an 25% extra tax on the Chinese consumer. In Germany, none of these huge sectors of the economy are subject to any investment restrictions. There are no equity caps, no limits on business scope distorting competition and if, for consumer protections reasons, a license is required, the relevant authority must grant the license if legal requirements are met. Otherwise it can be taken to court.

**- Manufacturing Industry: Huge areas are restricted**

Restrictions in the car industry

China would not have become the world's largest manufacturer and the world's largest exporter without huge investment in its manufacturing sector. China's greater strength in this area has not been matched by further opening.

The most striking field is car manufacturing**.** China's almost forty-year-old requirement that all foreign OEM manufacturers have to enter joint-ventures with Chinese as minority partners still stands. Even the rule that foreign manufacturers can only enter into two joint ventures has not been changed. Recent moves to slightly ease restrictions for some suppliers have not changed the overall trend to subject the automobile industry to tight state control. It also appears that possible future moves to open investment will be strictly limited to new areas like New Energy Vehicles.

High-tech Machinery, IT and other high – tech goods: New restrictions in sight

In high-tech machinery and IT traditionally there used to be relatively few direct investment restrictions. This is now changing - unfortunately in the wrong direction. "Made in China" 2025 is seen by many European and German companies as a master plan of the government to lend a hand to "indigenous" Chinese companies to wrest market share away from foreign- invested enterprises in virtually all important high tech sectors. Recent assurances that this is not the intention have not been followed up by visible action.

As for IT, we have witnessed a strong trend towards indigenous innovation and security-related restrictions. One obvious example is the internet, where many sites such as major foreign search engines and social networks that are important for business continue to be blocked, even more than in the past. The new cybersecurity law places severe controls on IT

for critical infrastructure. Aside from intrusive security reviews, the requirements include localization of servers, storage of all customer and critical company data in China, the use of Chinese-made IT-security solutions, the handing over of source codes, encryption keys and decryption schemes to the authorities. It seems now that the government could define “critical infrastructure” even more broadly than anticipated. If this were to be the case, this could become a massive obstacle to foreign investment in China in the IT sector. These policies and rules have thrown doubts on the prospects of maybe the most important future field for investment and trade of the machinery industry between Germany and China: “Industry 4.0.” which is nothing less than a revolution of manufacturing through digitization. China’s restrictive rules about IT so far do not contain any exceptions for Industry 4.0 applications.

In Germany, the situation is clear and simple: There are no restrictions with regard to investment in manufacturing. There is only one exception: Investment with direct relevance to national security, i.e. manufacturing for military use. This sector accounts for around 1% of German industry.

**- The rules behind the rules: “Buy Chinese” policies**

The absence of formal investment barriers by no means clears all hurdles for meaningful foreign investment. Take the fast-growing and highly lucrative medical devices industry. There are few direct rules banning or restricting foreign manufacturers. However, there are a multitude of instruments that tilt the playing field in favor of indigenous Chinese manufacturers. The relevant ministries have pressed public hospitals, by far the largest buyers of medical equipment in China, to buy “indigenous” medical equipment. This excludes all foreign-brand equipment, even devices made in China. A raft of State Council documents has reinforced this “buy indigenous Chinese” policy. This is only one example. We have similar government policies in place aggressively pushing customers to “buy indigenous Chinese”, for example in the food sector. The tendency to create a three-tier-hierarchy, with “indigenous Chinese” at the top, China-made foreign invested products in the middle and foreign made products at the bottom is getting stronger.

In Germany, there are neither formal nor informal rules requiring customers to “buy German”.

**What will the future hold?**

It has to be concluded that China places major legal or de-facto-restrictions in all investment fields that matter most. So far, in none of the most important sectors have we seen major moves by China to open its investment market further. Conversely, with respect to Chinese investment in Germany, there are virtually no restrictions. We need to see faster progress by China to create a level playing field for investment. If words are followed by action, the future for a true “win-win-“ relationship between Germany and China is bright.