Economic Relations between the PRC and the States of Europe

Markus Taube

Introduction

In the course of the last 20 or more years the intensity of economic exchange between the People’s Republic of China (henceforth China) and the various European economies has increased dramatically. This development was triggered largely by the economic policy changes introduced by Deng Xiaoping in 1978. Since then, China has freed itself from its former self-imposed isolation and gradually integrated with the world economy. The market-oriented transformation process initiated in China in the late 1970s created the preconditions for the resumption of economic contacts that had been largely stagnant in the preceding years. The gradual establishment of a market-based economic framework has step-by-step allowed economic entities to exploit the comparative advantages of the economies concerned and enlarge the scope of division of labour with China.

In the period in question, however, major shifts have also occurred in the world economy which have left their mark on the economic relations between China and various European economies. The single most important events bringing about a significant reshuffle of the European economies’ economic structure and the pattern of their integration into the international division of labour, have been the evolution of a single European market under the auspices of the European Union,¹ and the breakdown of the socialist block and the ensuing transformation of the Central and East European economies into market economies.² Both events have for many European enterprises opened markets in their vicinity that in terms of their comparative advantages and production capacities are somewhat similar to those in China and have resulted in the diversion of some economic interaction (especially investment and trade flows) that might otherwise have benefited China. This, however, could not stop the rapid intensification of economic relations between Europe and China. In this article the evolution of this economic partnership and its driving forces will be outlined. It is structured according to the various types of economic transactions: exchange of goods, foreign direct investment (FDI), and lending operations and official development aid. The conclusion will provide an outlook on the development of European–Chinese economic relations in the 21st century.

Until the present, economic transactions between China and the rather highly industrialized economies of Europe have typically been of a

¹. See Algieri in this volume.
². For Germany the single most important event has been the reunification of East and West Germany and the ensuing, rather painful, merger of the two economies.

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two-way nature in respect to foreign trade, i.e. the exchange of goods only. All others, such as foreign direct investment, lending (commercial and governmental) and development aid (transfer payments) have been in one direction: capital, management and technological know-how is transferred from these countries to China, but not vice versa. The analysis of these different types of economic transactions is complicated, on the one hand, by the fact that they are interrelated. The amount and direction of development aid has a strong impact on foreign trade and plays a facilitating role in foreign direct investments. Foreign direct investment influences the volume and composition of export/import flows. Its net effect may be trade creation or trade substitution. In the long run it may function as a substitute for certain categories of development aid. Foreign lending has a facilitating role in foreign trade as well as in foreign direct investment, and is, in certain areas, closely related to development aid. On the other hand, it must be taken into account that bilateral economic transactions are subject to a wide range of factors that have an impact on their development. They are dependent on political and institutional developments as well as macro-economic cycles in China; influenced by political and economic developments (business cycle) in the European economies; influenced by the progress of economic integration within the boundaries of the EC (EU); and influenced by economically relevant developments in other parts of the world, such as the business cycle in the United States or East Asia, and singular events, like the “Asian Crisis,” the disintegration of COMECON, and the transformation processes in Central and Eastern Europe and the successor states of the USSR.

As far as possible these parameters will be taken into account when discussing the development of economic relations between China and the various states of Europe. All statistical data presented in the analysis refer to the PRC as defined by its customs territory. Hong Kong, Macau and Taiwan are not covered.

Bilateral Trade Relations

In general the exchange of goods between China and Europe has grown tremendously during the last 20 years, although a clear distinction has to be made between the West European countries and the COMECON member countries. While trade relations between the former and China developed rapidly from early on, the latter experienced only sluggish growth in the beginning and started to show stronger growth only in the second half of the 1990s.³ This rapid growth of bilateral trade has not been an isolated phenomenon, but goes in line with the rapid integration of China into the global division of labour, which in turn is directly linked with the gradual replacement of existing command-

³. Due to limitations in space it is impossible to present here all statistical data collected and processed while preparing this article. These data have therefore been made available in Chear Taing and Markus Taube, Compilation of Key-Data on Sino-European Economic Relations Since 1978 (Duisburg: Duisburg Working Papers on East Asian Economic Studies 63, 2002).
Figure 1: The share of the PRC in world trade

Source:
International Monetary Fund, Direction of Trade Statistics Yearbook, Washington, various years. Own calculations.

economy structures by market-economy co-ordination mechanisms in the economy as a whole and in the foreign trade system in particular. In the last two decades China has massively increased the efficiency of its foreign trade and has also been able to adjust the structure of its trade to its own comparative advantage. This has made possible an expansion of trade that makes sense for all partners, and with the rapid growth of the Chinese economy, trade has received additional stimulus. These developments are mirrored in a general increase in the relative weight of China in world trade (Figure 1). The increasing share of China in world trade implies that China’s exports and imports have grown significantly faster than total world trade.

China’s trade relations with West European countries. A common feature in trade relations between all West European countries and China is that the importance of China as a trading partner for Western Europe has risen steadily, with China becoming much more important as a market to source imports than for exports. The consequence of this unbalanced trade structure for the West European countries is rising deficits in their bilateral trade balances. When looking at the corresponding data from the perspective of China, and the importance of West

5. Here, at the same time, is a countervailing causal relationship according to which the increasing opening of the Chinese economy to the international market has also stimulated the overall growth process. For a detailed presentation of this argument see Gershon Feder, “On exports and economic growth,” Journal of Development Economics, Vol. 12, No. 1–2 (1983), pp. 59–73.
European countries for Chinese exports and imports, the picture is much more diverse. While country-specific analyses are presented below, the general impression is that most West European countries have lost some of their relative importance as trading partners for China. Figures 2–3 depict these developments paradigmatically for France and Germany.
In the early days of modern European–Chinese trade relations it can be observed that trade relations intensified somewhat at the beginning of the reform era under Deng Xiaoping, but showed no dynamic growth until the mid-1980s. Thereafter trade stabilized again at a somewhat higher level. The short-lived boom at the end of the 1970s must be attributed to
the so-called “New Great Leap Forward” proclaimed by Beijing in 1977–78. During that period China once again tried to boost economic development by importing turnkey plants in various strategic industries. After decades of stagnating economic relations, the leading European industrial economies’ exports to China picked up considerably. Japanese and German suppliers in particular managed to secure a large share of the projected plant imports. German enterprises alone signed contracts valued at more than DM 10 billion. This boom, however, proved to be short-lived. Reluctance to widen the overall trade deficit beyond the 800 million yuan that were to be reached in 1980, an unexpected lack of foreign exchange due to unexpectedly low oil export revenues and, last but not least, the realization that China would not be able to make the complementary investments necessary to bring the projects on track all contributed to the decision to scale down the programme drastically. In November 1980 the Chinese side informed its contract partners that it would not be able to adhere to its contractual obligations and cancelled numerous projects.

In Europe the late 1970s and early 1980s were characterized by the shock of and slow recovery from the second oil price crisis. Structural rigidities (“eurosclerosis”) and a general disintensification of world trade were not conducive to European activities in the slowly opening Chinese market, especially after the disillusionment caused by the Chinese cancellation of import contracts when the “New Great Leap Forward” failed. German export activities were in addition hampered by the German government’s unwillingness to provide soft loans to China for any other means than safeguarding Germany’s raw materials supply, while other nations, like France and Italy, were much more willing to promote the export activities of their enterprises by means of interest-subsidized loans. In this early period French exports already featured a pattern that has remained characteristic until today: the predominance of singular large-scale contracts. During 1981–83 the export of agricultural products, primarily wheat, increased dramatically to constitute about one third of all French exports to China. In 1984, however, the share of agricultural exports to China fell back to less than 2 per cent, highlighting the political character of the deal.

In China, this period was marked by intensive discussions of principles. After the previous decade, when cross-border goods trade was stigmatized as the rich countries’ instrument of exploitation, it was necessary to arrive at a new understanding on the theoretical level, in order to bring the opening of foreign trade in line with the ideology of the Chinese leaders. This discussion of principles was only concluded in the mid-1980s by adopting Ricardo’s theory of comparative cost advantages by which both trading partners profit, even if one partner is superior in every respect.\(^{10}\) Until then, only a very cautious revitalization of foreign trade relations could be seen. Imports were tightly tied to the country’s ability to generate foreign exchange as trade deficits and debt financing were to be kept as low as possible.\(^{11}\) On the level of practical foreign trade policy, the ideological discussion was accompanied by an emphasis on import substitution. Active export promotion was only practised in a few selected locations, such as the newly created special economic zones and diverse goods-specific export-production bases.\(^{12}\)

The foundation for a transition to dynamic growth in cross-border goods trade was laid in 1985–86 when the group around Zhao Ziyang finally committed itself to a market-based economic system,\(^{13}\) and the ideological discussion of the character of foreign trade was concluded. In 1986 new reforms in the foreign trade system were announced, the official exchange rate was devalued, and China applied for (re-)admission to GATT. In 1987–88 Zhao Ziyang eventually announced a “Coastal Development Strategy” which was to promote the export economy in the coastal regions by assisting export processing firms and the settlement of firms with foreign capital interest.\(^{14}\)

Nevertheless, there was no substantial increase in most West European economies’ exports to China between the middle of the 1980s and 1992–93. The stagnation and even deterioration of German, Italian, British and other European economies’ export volumes during the latter half of the 1980s,\(^{15}\) after they had risen considerably between 1984 and 1986, is curious, as during that period the overall exports of these economies experienced very dynamic growth (as mirrored in China’s decreasing share in their overall exports). An explanation may be found in the theory of the “missing middle” as put forward by Bass. According

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15. French exports received a stimulus when in 1986 construction of the Daya Bay nuclear power plant started. The project lifted the share of industrial equipment in France’s China-bound exports to more than 70%.
to this, once the large multinational corporations had entered the market there were no companies left to mobilize the resources necessary to penetrate the still very difficult Chinese market.\textsuperscript{16} Prohibitive transaction costs therefore may have prevented a further intensification of trade relations which would have had to be shouldered by the small and medium-sized enterprises. The mystery however dissolves to a certain extent when taking into account China’s overall import situation during that period. China’s share of world imports decreased during the 1985–1990 period (see Figure 1). In absolute figures China’s overall import volume stagnated between 1985 and 1987. But it experienced a strong increase in 1988 and 1989 due to massive imports of pre-fabricated goods and raw materials along with the promotion of export processing businesses in the context of Zhao Ziyang’s coastal development strategy. These export processing businesses however were not suited to expand European exports to China. Rather they diverted European import flows in China’s favour. Goods which until then had been procured from Hong Kong, Taiwan and South-East Asia in general, now increasingly underwent value-adding processes in China, from where they were finally exported to Europe and the world in general.

The 1989–91 period is characterized by a general deterioration of the political setting embracing European trade relations with China. In reaction to the Tiananmen massacre in June 1989 export assistance programmes and development aid were drastically curtailed. These measures, however, did not dramatically reduce exports to China. Overall the European economies’ exports to China stabilized at the levels reached before the incident.\textsuperscript{17} This is all the more remarkable as two more factors negatively influenced the China-trade during this period. The most important resulted from an administratively induced general reduction of China’s imports. Being part of a comprehensive austerity and consolidation programme, designed to lead the economy back to a balanced, sustainable development path, the import reduction led to a drop in overall imports by 10 per cent in 1990.\textsuperscript{18} Another factor contributing to a reduced intensity of exports to China can, last but not least, be found in the collapse of the socialist bloc. The new opportunity to enter the East European market diverted (potential) business from China.

1992 marks a turning point in China’s recent history. In this year the reformers regained dominance over more conservative forces and brought

\begin{itemize}
\item 17. A remarkable exception is France. French exports to China were boosted by another major wheat deal in 1989. In addition, the implementation of formerly concluded large contracts elevated the volume of French exports to new heights, despite the adverse conditions in the aftermath of the Tiananmen massacre. Further, France was the first EC member country to loosen economic sanctions against China – in late 1989. In early 1990 COFACE fully resumed issuing public guarantees for export credits in the China trade. François Godement, “Between the gold rush and political trade: France’s approach to the China market,” in Ost-West-Kolleg der Bundeszentrale für Politische Bildung; Friedrich Ebert Stiftung (ed.), \textit{China’s International Role: Key Issues, Common Interests, Different Approaches} (Bonn: Friedrich Ebert Stiftung, 1997), pp. 81–93, here pp. 81f.
\item 18. This episode highlights the fact that until the early 1990s, China’s foreign trade transactions were subject to heavy-handed administrative guidance and strongly influenced by the government’s planning and investment cycles.
\end{itemize}
new momentum to China’s transformation towards a market economy. The intention further to open China to the world economy was underlined by the start of serious GATT-membership negotiations. Only with this resumption of the reform process could European economies once again realize significant increases in their export volumes. But despite this general trend of increasing trade volumes, the situation of the various economies varied considerably.

The main characteristic of policy towards French exports to China may be said to be a high sensitivity for France’s global arms sales and for those to Taiwan in particular, and an over-dependency on single large-scale contracts, les grand contrats. These characteristics led to a strong politicization of Sino-French trade relations, which at some times have been shaped by criteria other than economic. This pattern was especially valid for the 1990s. 1992 was overshadowed by the sale of six frigates to Taiwan and the initiation of negotiations concerning the sale of 60 Mirage 2000 fighters to Taiwan. Although Paris tried to cushion the adverse effects of these deals with a generous provision of official development aid, Beijing reacted harshly, closed the French consulate-general in Guangzhou, discriminated against French companies (they were excluded from the Guangzhou subway bidding process) and refrained from any large-scale purchases of French wheat until 1995. In this period, however, also began one of France’s major export success stories, the Airbus. In spring 1993 the first significant sale of Airbus (six A-340 planes) was concluded with a German government visitor, although French aerospace contractors would take responsibility for the major part of the production process. Since then the delivery schedule of Airbus planes has had a decisive impact on the volume of France’s China-bound exports. In 1999, for example, Airbus sales accounted for 29 per cent of total French exports to China.

The UK’s export business during the 1990s was heavily influenced by the dispute with Beijing over the conditions of Hong Kong’s return to mainland China. Having experienced a marked increase in export volumes during 1992 and 1993, British exports to China then hovered at that level and did not participate in the strong increases that most other

19. European exports to China might have gone through an even more dynamic development, but a weak US dollar in the 1993–96 period put European exporters in a relatively disadvantaged position vis-à-vis their US competitors.
22. Lost large-scale deals, however, were more than compensated by an export boom of French small and medium sized enterprises, which were responsible for a marked increase in French exports to China even in this period of political tension. Godemont, “Gold rush,” pp. 86f.
23. In 1996 Li Peng signed another deal covering 33 Airbuses in Paris. As the six planes from 1993, however, were reincluded in the contract, the new order volume was 27 planes only.
European economies experienced. This development has to be understood as a conscious “sanction” by the Chinese side, which, enraged by Chris Patten’s efforts to install democratic principles in Hong Kong, shut British companies out of public bidding processes and contracts and favoured other European suppliers. British endeavours to improve bilateral relations, including high-level visits and the offer of a very substantial export credit guarantee scheme, commenced in 1995 and in 1997 eventually contributed to a marked increase in British exports to China. Since then exports to China have picked up considerably and increased their relative importance in British total exports by more than 50 per cent.

Germany has certainly been able to profit from Chinese disenchantment with Britain, France and also the US during this period – at least from 1993 until 1996, when it itself became the target of Chinese sanctions brought about by Beijing’s intolerance of a cultural festival involving Chinese dissidents and a conference on Tibet. Until then a significant improvement in the bilateral political climate could be seen. During this period Germany not only lifted its sanctions against China – which until then it had upheld much more strictly than other Western industrial countries – but also refrained from selling submarines to Taiwan. All this contributed markedly to an improvement of economic relations, which were also promoted by German export subsidies for the Chinese market. German soft loans contributed greatly to the sale of container ships, wagons and subway facilities to China. But Germany’s China-bound exports are perhaps most of all promoted by the German and eventually global FDI-commitment in China. In the mid-1990s about two-thirds of Germany’s exports to China had been ordered by foreign invested enterprises (FIE) which imported German capital goods (initially machinery, automobiles and electro-technical products).

In contrast to the comparatively moderate and quite volatile development of exports, the West European economies’ imports from China clearly show a more dynamic growth. Since 1986 their imports from China have grown steadily, thereby ending the generally equal volume of export and import flows in the late 1970s and 1980s. In the 1990s, the West European economies have all built up massive trade deficits with China. There are many reasons for the import surge and the balance of trade developments.

1. These developments reflect the consistent implementation of an

export-oriented foreign trade strategy and a rapid catching-up process of the Chinese economy, which, especially in the early 1980s, was not in a position to offset its imports of European goods with goods of its own production that could be sold in Europe. During the 1990s this export weakness was overcome.

(2) European investment projects in China made an important contribution. As more ventures began production during the 1990s, they not only became important suppliers for European imports but also increasingly substituted European exports to China as they entered the local market. The coming of age of Europe’s own foreign investment activities in China therefore delivered a double blow to the European economies’ trade balances with China. As mentioned above, however, these foreign invested enterprises are also major buyers of European capital goods, which makes it almost impossible to ascertain the net effects on the bilateral trade balances of economies like the UK and Germany where these industries are highly developed.

(3) As mentioned above, the rise of export processing businesses in China has led to a redirection of European import flows in China’s favour as production facilities have been moved from Hong Kong, Macau, Taiwan and South-East Asia in general. Imports which until then had been classified as originating from those countries, now originate from China.30

(4) The surge in imports was also considerably boosted by EU assistance measures. China was included in the EC’s System of Generalized Tariff Preferences (GSP)31 in 1980 and has since then become one of its greatest beneficiaries.32 While China enjoyed about 5 to 6 per cent of the total GSP benefits granted by the EC in the early 1980s, this share rose to more than 25 per cent in the mid-1990s, although the

30. With respect to these goods we therefore cannot observe a deterioration of the European economies’ overall trade balances, as widening trade deficits with China should have been neutralized by improving trade balances with the relocating economies.

31. The GSP scheme has been designed to strengthen the export activities of developing countries in the markets of the developed industrialized countries. Its main feature is non-reciprocal tariff preferences granted to developing countries for selected goods and quantities thereof. The preferential rates are determined with respect to the developmental state of the beneficiary country (GDP per capita and other indicators), the countries’ efforts to combat the drug industry, the countries’ share of total EU imports of a certain GSP-treatment eligible product, the classification of the product under consideration as “very sensitive,” “sensitive,” “semi-sensitive” or “non-sensitive.” Antonia Giulia Carzaniga, The EU’s Trade Relations with China: Anti-Dumping Policy and The New Generalized System of Preferences (Brussels: CEPS, 1997), pp. 3–6; Roger Strange, “EU trade policy towards China,” in Roger Strange, Jim Slater, Wang Limin (eds.), Trade and Investment in China. The European Experience (London and New York: Routledge, 1998), pp. 59–80, here pp. 63–66.

32. It should be noted that, while the GSP scheme was directed towards all developing countries, its terms were less generous than the concessions agreed upon under the Lomé Convention and the Mediterranean Agreements. Therefore, only countries not included in the latter preferential systems applied for GSP treatment. But, at the same time as the EC promoted Chinese exports to Europe, China was also the main target of protectionist measures on behalf of the EC, bringing about a sub-optimal level of economic interaction between China and the various European countries. But, all in all, trade creation is regarded as the dominant effect, although on the product level European protectionism has in some cases led to the de facto exclusion of Chinese exporters from the European market (see n. 36).
number of countries eligible for GSP treatment increased dramatically with the inclusion of East European and USSR successor states. The value of imports to EU member countries from China that fell under the GSP scheme in 1995 amounted to 53.6 per cent of total EU imports from China. However, because of China’s dominating role in the mid-1990s, the EU has since been phasing out GSP preferences towards it. At the same time it must be noted that export subsidies and a distorted price structure, at least until the mid-1990s, had so enhanced the price competitiveness of some Chinese exporters that it seemed to warrant the label “dumping” and made China the target of numerous anti-dumping measures by the EU.

(5) While China has been promoting an export-driven growth process in various areas, it has also taken recourse to extensive protection of domestic industries thought unfit for international competition. These measures have seriously inhibited European sales and reduced the European economies’ trade balances with China.

In the course of these developments the composition of European exports to and imports from China has changed rapidly. At the end of the 1990s, European exports to China were dominated by machinery and electronic equipment. Imports from China covered a broad range of goods. Most are still labour-intensive products of lower price and quality, but this trend has been decreasing over time. Textiles and apparel, the bulk of imports in the past, are also less important. In contrast to the typical export structures of developing economies, Chinese exports, and especially those to the European highly industrialized economies, are largely (about 90 per cent) finished products, because of the large contribution of foreign investment enterprises, more than 40 per cent, to China’s total exports.

34. Eurostat, External Trade: System of Generalized Tariff Preferences (GSP), Luxembourg, various years; and: Eurostat, Außen- und Intrahandel der Europäischen Union, Luxembourg, various years.
36. During the 1990s, China was the country against which the most antidumping measures were implemented: in the mid-1990s about 5% of EU imports from China were either already subjected to anti-dumping measures or were already involved in an anti-dumping procedure. Not all of these anti-dumping measures, however, can be accepted as warranted. There has also been a good deal of protectionism by the EU, which reduced the level of economic interaction too far. In some cases European protectionism has led to the de facto exclusion of Chinese exporters from the European market. This happened for example during the early 1990s in the markets for tungstic oxide and tungstic acid, barium chloride, small colour television sets etc. See: Fu Donghui, “EC anti-dumping law and individual treatment policy in cases involving imports from China,” Journal of World Trade, Vol. 31/1 (1997), pp. 73–105, here pp. 78f.; Strange, “EU trade policy,” passim, especially p. 70.
The general trends in the volume of bilateral trade between Western Europe and China may be identified as follows:

- The volumes of bilateral imports and exports have risen dramatically, with the most dynamic development during the 1990s.
- As trade partners the West European economies are more important to China than vice versa.
- China’s share in total imports to European countries has risen continuously over the past 20 or more years. China has become an important source for European imports.
- From the Chinese perspective, the importance of Western Europe as an destination for direct exports has not significantly improved, rather the opposite. The share of Chinese exports to Germany has for the past 20 years been extraordinarily constant, at about 4 per cent of total exports. Chinese exports to Germany thus grew at the same pace as total Chinese exports. In the case of France and Italy, the share of China’s total exports stabilized at about 1.5 per cent only after the early 1980s. This level marks a decline from the level in the middle of the 1970s which was twice as high. The UK’s share of total Chinese exports has been quite volatile.
- From the major European economies’ perspective China’s importance as an export market has risen, by two to three times on average. But this rise in relative importance lags far behind the corresponding values for imports and still hovers at the 1 per cent level of total exports.
- The importance of the West European economies for total Chinese imports fluctuated greatly in the past two decades. The comparatively greatest stability in relative importance is observable for France; Germany and the UK tended to lose in importance while Italy was able to build up a comparatively strong position.

**China’s trade relations with East European countries.** A quite different picture from that of the West European countries’ development of trade relations with China is seen in China’s relations with the former COMECON countries. Not only are the absolute volumes of bilateral trade markedly smaller than those with Western Europe, but the mutual dependencies are also reversed: China has been a much more important foreign trade partner for Eastern Europe than vice versa (see for an example Figures 4–5). And whereas Chinese/Western European trade relations were primarily determined by developments in China itself (in the sense that efforts of West European companies to intensify business relationships were restricted mostly by problems that arose on the Chinese side), the main restricting factor in the development of trade relations with Eastern Europe seems to have been inherent to these countries. In the 1980s it was the structural rigidities, political dependencies and ideological principles that these countries were subject to in the COMECON group. And after the dissolution of the socialist bloc in the early 1990s, these countries underwent a fundamental transformation.
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crisis. Not until the end of the decade had the East European economies stabilized enough for economic relations with China to intensify.

During the second half of the 1970s in Eastern Europe the rapidly increasing volume of trade in goods with China gave rise to hopes for a profitable intensification of economic co-operation. However, the volume of trade in the 1980s deteriorated dramatically. And although bilateral trade agreements covering the period 1986–1990 resulted in substantial increases in bilateral trade flows for East Germany, Hungary and Poland, the exchange of goods remained markedly below the quantities that had been planned.

The primary cause was the limited ability of the East European economies to adjust their export range to the rapidly increasing needs of the Chinese customers. Initially it had still been possible to sell goods in China that would have been difficult to sell elsewhere. But the technological and qualitative inferiority of the East European supplies quickly became evident during China’s rapid economic development. As Chinese importers had better access to suppliers from Western industrial countries during the 1980s, China’s interest in East European products vanished and East European producers came to occupy almost automatically an inferior position vis-à-vis their Western competitors.

On the other hand, China became an increasingly interesting supplier of goods which the East European economies would otherwise have had to buy in the West with hard currency. In contrast to the continuously weakening Chinese demand for East European products, there existed a remarkable interest in Chinese goods in Eastern Europe. But, given an insufficient export performance and the political maxim of a balanced bilateral trade balance, this demand could not lead to increasing trade volumes. The bilateral division of labour remained on a sub-optimum level. This was further aggravated by the fact that the East European economic system made it impossible to enlarge the scope of economic co-operation to new fields like joint ventures etc., which might have provided a stimulus for bilateral trade development. The Chinese side made an effort to break up the unsatisfactory state of bilateral trade relations by proposing to eliminate the existing clearing system, which controlled a strict balance of exports and imports. Instead bilateral trade should be based on payment in hard currency, as with transactions with Western countries. This would have been the only way to replace the constraints in the clearing system and to expand Chinese exports beyond the extent of East European goods shipments. This request, however, was rejected. The East European–Chinese trade relations were therefore stuck in a rigid institutional framework. Without dramatic alterations of the East European economies’ foreign trade regime no improvement of this situation was possible. 38

Figure 4: **Indicators of trade relations between Hungary and the PRC**

(a) Trade balance between Hungary and the PRC China
in Mio. US-


(b) Export and import of Hungary with the PR China
in % of total Hungarian exports and imports


(c) China's export and import with Hungary
in % of total Chinese exports and imports

--- Exports --- Imports

**Source:**

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*footnote continued*

Until the fall of the Iron Curtain, bilateral trade relations between the East European countries and China therefore remained underdeveloped and could not grow. But even then, the transformation shock of the market-economy restructuring in Eastern Europe further delayed this
growth until the end of the 1990s. The development of bilateral trade has furthermore been hampered by the comparatively strong substitutability of their respective export structures. The East European economies and China have been competing for market shares in Western Europe rather than complementing each other. The general trends may be summarized as follows:

- The volumes of bilateral trade have changed significantly. While East European exports to China have deteriorated dramatically and still have not reached the volumes of 20 years ago, imports from China have risen substantially (although less so in Romania).
- China was much more important for the foreign trade of the East European countries than vice versa. The shares of East European countries in China’s total trade volume have by now declined to an insignificant quantity. This is particularly obvious in the case of Romania, which at the end of the 1970s still had a 4 per cent share of Chinese imports and exports.
- The importance of China as a trading partner has developed in a different way for the countries under observation. For Hungary and Poland, China gained dramatically in importance in the second half of the 1980s. The high levels of trade were reversed, however, with the fall of the Iron Curtain. The importance of China as a trading partner slipped to all-time lows. Since then the parallel development of imports and exports has been interrupted. Whereas China as an export market has continued to lose importance, the relative importance of China as an import market has risen clearly and is now far above the level of the end of the 1970s and the beginning of the 1980s. In the case of Romania, however, up to 1990 China had a relatively stable share of exports and imports, but China’s share of imports then slumped and is now only at about a third of the level of the 1980s. From the beginning of the 1990s exports clearly increased in importance. But in the second half of the 1990s they massively declined here too.
- The shares of East European countries in China’s total exports and imports declined constantly in the past two decades. Only Hungary and Poland have been able to regain importance from the absolute low point reached in 1990–91.

In order to enlarge the scope of the analysis presented above and evaluate the relative importance of bilateral trade relationships in the context of the world market integration of the concerned economies the Intensity of Trade Index has been calculated.

In a formulation based on exports it is defined as the share of exports of the country of origin aimed at the target country divided by the share of the target country in world imports which theoretically could have the beginnings in the country of origin. An analogous definition holds for the import side. If the index assumes the value of 1, the export country directs precisely that portion of its exports to the target country as this country’s share in world imports. Accordingly, a value above or below 1 indicates an above or below average intensity of goods trade.
Figure 6: **Intensity of Trade between selected Western European countries and China**

(a) Exports to China

(b) Imports from China


Figures 6–7 show the corresponding values for the import and export relationships of four West European countries and four East European economies plus East Germany (until 1990) with China (European perspective).
A salient feature of this analysis is the wide divergence of the index values the West and East European economies commanded especially during the early 1980s.
Looking at the West European data first, no clear upward or downward trend is noticeable in the intensity of West European export activities with China. The values oscillate in a rather small range clearly below the unity threshold, with Germany and Italy featuring the highest values on average. The least intensive contacts are shown for the UK. West European imports, in contrast, clearly intensify. Germany in particular came close to achieving parity during the 1990s. France and Italy follow the same trend as Germany, while the UK did not experience a dynamic development. The intensity index data line remains flat. As the index values never reached unity we have to understand that despite this expansion of the West European economies’ China trade, trade relations have not yet assumed the intensity that would accord with the relative world market shares of these countries. An explanation for this disparity is the West European economies’ close regional ties to their European neighbours, i.e. the EU member states and (since the 1990s) the transformation economies of Eastern Europe, on the one hand, and China’s embeddedness in the Asian regional economy (most of all Hong Kong, South-East Asia, Japan), on the other. Here, the forces of regional gravitation still seem to prevail over “globalization.”

The picture that unfolds with respect to the East European economies is decidedly different. Despite the very hesitant unfolding of trade relations in the late 1970s and early 1980s (in absolute numbers), the Intensity of Trade Index for these years shows extremely high values. Being clearly above unity, the Index values suggest an above average intensity of bilateral trade. This however misrepresents the actual situation as it reflects the low volume of foreign trade the East European economies maintained outside the Soviet bloc. Only against the background of such a small basis of extra-COMECON trade could the modest transaction volumes with China attain such a weight.\textsuperscript{39} With the continuing dissolution of the COMECON structures and the gradual integration of the East European countries in the international economy, the intensity of trade relations with China has declined accordingly. The index values have declined steadily and have been clearly below unity since the early 1990s.

\textit{Foreign Direct Investment}

The initial legal and institutional basis for an inflow of FDI to China was established only in the late 1970s and early 1980s. Since then China has taken a number of measures to intensify the flow of FDI to the country. Special economic zones and industrial parks have been established within which foreign invested enterprises experience a better regulatory environment and infrastructure facilities than in other parts of the country. They have been given tax benefits, promised a relatively liberal foreign-trade regime, and granted other special conditions under which the business activities of companies with foreign participation are

\textsuperscript{39} Against this background it becomes understandable that Hungary, i.e. the country least integrated in these structures and with the strongest business contacts to the industrial countries of the West, featured the lowest Index values of the countries observed.
subject to different conditions from businesses that are financed purely by Chinese capital. But, still seriously constricted by regional, sectoral restrictions and specific qualifications (concerning foreign exchange balances, local content regulations, access to the local goods and factor markets, etc.) motivated by ideological reservations that they might allow foreign capitalists to exploit the country, FDI inflows picked up only slowly in the 1980s. It was only with China’s strong commitment to a market economy in the early 1990s that the country was able to attract truly substantial amounts of FDI. Since then the development has been dramatic. Between 1995 and 1999 China absorbed 7.5 per cent of global FDI flows and about one quarter of all FDI flows directed towards developing countries. From 1993 to 1996 China even received more than one-tenth of global FDI.

The bulk of these massive FDI inflows did not, interestingly, stem from the world economy’s industrial growth centres. As documented in Table 1, the three economies of the EU, Japan and the US each accounted for only about 10 per cent of all China-bound FDI, while Hong Kong, Taiwan and Singapore produced about one-half. Even if potential misrep-resentations arising through investments made by affiliates of European companies registered in Hong Kong, Singapore, Virgin Islands etc., and as a result not appearing as European FDI, are taken into consideration, the quantitative European FDI engagement in China was moderate when taking into account the size of the economies. The East European economies are barely represented with foreign invested enterprises.

The comparatively weak presence of the European economies in China can largely be explained by historical developments in Europe itself. The dynamic progress in the process of European integration and of German reunification as well as the new possibility to access East European markets, absorbed substantial amounts of capital and management capacity that otherwise might have been allocated to ventures in China. The moderate relative share of the West European economies, however, cannot hide the fact that the absolute volumes of China-bound FDI flows have multiplied in recent years (see Appendix 1). British enterprises’ actually realized FDI in China for example amounted to only US$71.6 million in 1985, but rose to US$1,164.1 million in 2000. In the same period German FDI flows rose from US$24.1 to US$1,041.5 million while French enterprises committed US$32.5 million in 1985, but US$853.2 million in 2000.

42. It is interesting to note that in 1992, the first year of substantial FDI inflows to China, FDI flows to South Korea and Taiwan dropped by 31% and 51%. See: United Nations, World Investment Report (New York–Geneva: United Nations).
43. Ibid.
44. During the late 1990s the European economies experienced a modest increase as, due to the Asian crisis, the main investors in China located in South-East Asia could not invest further.
Table 1: China-bound FDI by country of origin as a percentage of total FDI inflows to China

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<td>2.6</td>
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<td>0.4</td>
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<td>8.6</td>
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<td>n.a.</td>
<td>0.8</td>
<td>8.9</td>
<td>9.4</td>
</tr>
</tbody>
</table>

Source: Calculations on the basis of data from Guojia tongji ju (National Bureau of Statistics), Zhongguo tongji nianjian (China Statistical Yearbook), Beijing, various years.

The growth of European investment in China follows the general trend of China’s market transformation and its opening to the world economy. The 1980s were characterized by a wait-and-see attitude reflecting the institutional deficiencies in China’s FDI regulations and doubts about the commitment of China’s leadership to this mode of economic interaction. The watershed was reached only when clear signals came from the political realm that the Party leadership was strongly committed to world market integration. With Deng Xiaoping’s travels to the southern provinces in spring 1992, and the subsequent Party Congress, internal Chinese resistance was broken and foreign investors were reassured of a secure political environment. Coupled with the lifting of the austerity policy, which had been in effect to 1991, and the beginning economic

45. The evolution of China’s legislation on foreign invested enterprises has been a comparatively slow process, which for long periods left wide areas unregulated and open for negotiation.

46. During this period the central government was not really emphasizing the need to attract FDI. Reflecting on the Chinese policy towards FDI in the 1980s, Khan points out that “while the Chinese government has introduced various laws and regulations and developed certain facilities for attracting foreign investment, it has not sought such investment aggressively. Its overall approach has been somewhat passive, basically waiting for investors to come up with their proposals for approval.” Khan, Patterns, p. 25.

upswing, the overall conditions for FIE in China appeared to be more favourable. Global and European FDI flows towards China picked up markedly. Since then the institutional factors have continued to improve and facilitated FDI inflows that find increasingly favourable investment projects. China’s entry to the WTO, in December 2001, will further stimulate European FDI engagement in China.

European FDI to China has until now mostly been “resource seeking.” It has been attracted by the low cost of production in China and less by the size and potential of the Chinese market. Consequently a considerable share of FIE production has been exported, and not been sold on the Chinese market. With more liberal FDI regulations resulting in better access to the Chinese market, and rising purchasing power of Chinese customers, the character of European FDI is changing gradually. “Market seeking” FDI is becoming more important and is expected to become the main mode of China-bound FDI as China enters the WTO.

In contrast to its comparatively weak trade relations with China, the UK is the main European investor in China. According to Ministry of Foreign Trade and Economic Co-operation sources its FDI in China amounted to 2.86 per cent of the world’s total in 2000, while Germany had 2.56 per cent, France 2.09 per cent and the Netherlands 1.94 per cent. British companies have profited from their strong presence in Hong Kong, which provided them with an ideal basis to explore business opportunities in mainland China, gain experience in dealing with Chinese cadres and business people, and train personnel in Hong Kong before sending them to the mainland.

In 2000, all the major European multinational corporations (MNC) are represented in China with FIE. In their wake a number of small and medium-sized enterprises have also entered the Chinese market as they took advantage of a “protective umbrella” provided by an MNC and its order guarantees, or submitted to pressure by MNCs that wish to have a specific product from the same supplier world-wide. The bulk of Europe’s small and medium-sized enterprises, however, are still hesitant to establish their own FIEs in China. These enterprises, which constitute the backbone of the smaller European economies but also those of Germany and Italy, are prevented from entering because of the high risks caused by the lack of transparency of the Chinese market and the need to commit substantial capital and management resources while having to wait for perhaps a considerable time until the ventures become profitable.

48. It should be noted that this upswing of FDI inflows to China coincides with a general increase in FDI flows to developing countries. Average annual flows directed towards developing countries in 1990–93 were double those of 1987–89. Nicholas R. Lardy, “The role of foreign trade and investment in China’s economic transformation,” The China Quarterly, No. 144 (1995), pp. 1064–1082, here p. 1066.
50. In the wake of Volkswagen, for example, more than 100 suppliers set up their own FIEs in China.
In terms of the intensity of the division of labour the FDI boom in the 1990s has come close to a quantum leap in the bilateral relations between most European economies and China. As FDI represent the simultaneous transfer of capital, capital goods and human capital they embody a much broader range of exchange than ordinary trade in goods. It is not only (fabricated) goods that are exchanged, but production capacity. New factor combinations and an improved exploitation of comparative advantages bring about a reconfiguration of relative prices, a redirection of trade flows – and mostly increasing trade volumes as well\(^51\) – and eventually an acceleration of structural change.

Global FDI-flows to China, European among them, have significantly contributed to economic growth and development in China.\(^52\) And although these amount to only about one per cent of their overall FDI outflows\(^53\) they have also exerted considerable influence on the European economies and their interaction with other actors in the world economy. Labour-intensive industries in Europe, such as shoes and textiles, have been cut back more quickly, while the capital and technology-intensive sectors have received a development push. All this has of course been accompanied by frictions on the labour market.

The structure of European imports has been strongly influenced by the production of European FIEs located in China, that are (mostly) taking advantage of low labour costs in China and are now producing in China for the European market. And, as stated, there was a considerable diversion of trade when production processes were moved from Hong Kong, Taiwan and South-East Asia to China, which impacted European import structures.

European exports have on the one hand experienced a stimulus from FIEs located in China which have become major clients for European suppliers, absorbing the largest part of Europe’s exports to China. But trade flows have also been diverted. Although Eastern Europe may be the preferred location for West European export processing businesses targeting the European market, European production plants have also been moved to China, from where they supply customers in Asia and the Americas. In addition more European enterprises are implementing globalization strategies based on the concept of only one large production site each in Europe, the Americas and Asia, and are choosing China as their Asian location – thereby substituting European exports into the region.

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\(^{52}\) We cannot go into details in this paper. FDI inflows have not contributed to domestic capital formation in China on a net basis. FDI (and other forms of capital imports) have not been employed to expand the build-up of industrial capacity beyond the degree that could have been financed by domestic savings. Their growth-enhancing impact rather stems from their ability to close the “technological” gap, create a substantial number of new jobs, and develop an export-oriented industry. See Lardy, “The role,” pp. 1073–75.

\(^{53}\) The major portion of the direct investments of the EU-15 countries remains within the borders of the EU or is in the US or Japan (i.e. it remains in the confines of the “triad”).
Lending Operations and Official Development Aid

The provision of credit lines for China in the past two decades was often caught between the commercial interests of the lenders, export assistance measures of individual European governments and development-policy-motivated transfer payments. Most of the credit lines extended to China have been mixed loans in which commercial credit transactions are combined with loan subsidies, state loan guarantees, etc. The favourable financing conditions offered China from such state subsidies are used as an instrument for supporting the national export economy vis-à-vis competitors from other European or other countries. China thus has been profiting from competition between the creditor/donor countries, which seem to be prepared to “reward” China for awarding contracts to “its” companies with the provision of governmental transfer payments. At stake are usually not just single contracts, but the establishment of systemic solutions\(^5\) that may strengthen the attachment and even dependence of Chinese industries to national suppliers. Largely ODA financed infrastructure projects in China like the French Daya Bay nuclear power plant or the German Transrapid have the additional effect of creating showcases of national technology whose marketing value reaches far beyond the Chinese market.

After Japan, which has been contributing by far the largest amounts of ODA to China, the European economies, especially Germany, France and Italy, have been the main sources of ODA to China. With the exception of the period 1987 to 1992 when France and Italy were the major European sources of ODA to China, Germany has been providing the bulk of European development assistance to China (see Appendix 2). In the latter half of the 1990s German ODA constituted more than half of total EU Commission plus EU member countries’ ODA disbursements. At the same time China has become also the most important partner country for Germany’s developmental aid activities, absorbing about one-tenth of its overall bilateral ODA. There is no doubt that these disbursements had a positive effect on the export activities of German enterprises.

The European country providing China with the largest amount of foreign credit, however, is France (which in some years provided up to 12 per cent of China’s total foreign borrowing), followed by the UK, Germany, Italy and Spain. The UK, which until 1994 used to be the second largest European lender, drastically cut back its China exposure in the second half of the 1990s. However German credit flows to China became larger in 1996 and 1997, at a time when most other European countries reduced their lending to China dramatically.

Overall, the development and structural composition of Chinese for-

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\(^5\) Systemic solutions are understood as complex technological systems that command a fixed set of complementary products. Implicating that once the decision for a certain system and its industrial standards has been made, complementary goods will automatically be requested by the host country, while other systems and their complementary products remain excluded. Examples for competing systemic solutions are, in the telecommunications sector, the GSM and CDMA technologies, in the transport sector the French TGV versus the German ICE system etc.
eign liabilities shows, however, that China aimed at preventing a potential destabilization of the macroeconomic situation through excessive credit volume, or from a heavy weight of short-term liabilities in its external debt. On the contrary, in reaction to the Mexican financial crisis in 1994, a remarkable sensitivity to financial distress became evident. At the onset of the Mexican crisis, foreign borrowing fell instantly from $11 billion in 1993 to $9 billion in 1994 and $10 billion in 1995. China has certainly not followed a “growth-cum-debt” development strategy.

For foreign lenders the provision of credit lines to Chinese borrowers appeared relatively risk free during the 1980s and early 1990s. Regardless of whether the government itself or subordinate units acted as borrowers, it was assumed that, on the basis of the centrally administered nature of the economy, all the debts of Chinese agents were ultimately sovereign liabilities for the performance of which the state would stand in. As the transformation of the Chinese economy and the subsequent transition to a market-based economic order progressed, however, this position became less viable. Nevertheless, numerous lenders continued to hold this position even after 1995, when the Chinese government stopped awarding guarantees for loans in the business sector. But when, with the Guangdong International Trust and Investment Corporation (GITIC), for the first time a Chinese financial institution went bankrupt in 1998 and the government did not assume its liabilities, it became certain that not all loans to China are sovereign debt.

For a European commercial lender this means that project studies and risk analyses have to be prepared more carefully and comprehensively. In the face of the arcane accounting methods of most Chinese businesses this, however involves serious problems. As a result the new quality of credit relationships with China has not only increased China’s cost of borrowing, but has also led to a decline in commercial credit flows, to the extent that the now indispensable risk analyses cannot be conducted, because of problems of implementation.

**Conclusion: Sino-European Economic Relations in the 21st Century**

With the effects of the external shock caused by the break-up of the Soviet bloc and the dissolution of the GDR slowly abating, the next decades of European-Chinese economic relations will be determined above all by China’s accession to the WTO. It is expected that in the mid-term the WTO entry will boost economic development in China.57

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55. Guojia tongji ju (National Bureau of Statistics), Zhongguo duiwai jingji tongji nianjian (China Foreign Economic Relations Statistical Yearbook), Beijing, various years.
57. In the short term, however, the economy and society at large will have to master a period of instability as strains on the labour market will increase and a comparatively large group of people will grow more discontented, as, for the first time in two decades of economic reform, they will have to suffer net-welfare losses. These will be individuals with earnings mainly from agriculture and state-owned industries. Efforts to alleviate these hardships will continue to motivate China to side-step existing commitments with respect to a comprehen-
Growth impulses will result first of all from an improvement in terms of the organizational (institutional) set up of economic interaction in China itself and between China and the rest of the world; from a more intense division of labour between China and the rest of the world which, in addition, will comply much better with the comparative advantages of the economies involved; and from productivity gains resulting from increased competition in the Chinese market. These factors will lead to a substantial improvement of factor allocation in China and, therefore, a more efficient use of available resources.

The elimination of barriers to bilateral trade in China as well as in the EU will lead to a substantial increase in bilateral trade volumes. There will also be a comprehensive reshuffle in the composition of imports and exports as falling tariff and non-tariff barriers will substantially alter relative prices. In the course of these developments the major West European economies’ negative trade balances with China will probably expand, although only slightly, as the terms of trade effects will act in favour of the industrialized economies.58 This quite positive evaluation does not apply to the less developed economies in the EU and even less to the East European economies. They will lose some of their present transaction cost advantages vis-à-vis China and may find a new competitor in West European markets. The changes in relative prices caused by China’s WTO entry will induce a rearrangement and re-allocation of production capacities on a global scale, during which processes of structural change already under way in Europe will become more rapid, and Europe’s most underdeveloped and structurally underprivileged regions will have to bear the strongest pressure.

West European enterprises are expected to (re-)locate production capacities to China, and at least part of this will not constitute net additions to their global production capacities but be at the expense of European locations. Improved market access and a general liberalization of the economic regime governing foreign invested enterprises will induce an upsurge of FDI in China. According to UNCTAD estimates, FDI inflows to China may more than double to US$100 billion a year in 2006.59 West European enterprises can be expected to increase their commitment to the Chinese market considerably, as the adaptation period granted to China will probably be the last chance to position an enterprise in the Chinese market before market shares are distributed. Once these market structures

58. The expected increase in Chinese exports will make China’s main export goods less scarce on the world market and therefore reduce their prices. At the same time, the expected import surge of Chinese economic actors will bring about an increase in the prices of China’s main import goods as – at least in the short term – they become more scarce. Therefore, the terms of trade of industrialized economies like Germany are going to improve, as their imports become cheaper and their exports are expected to command higher prices. This development will not be confined to bilateral, e.g. German–Chinese, trade relations, but will apply to all transactions in the goods concerned, as arbitrage processes will lead to price corrections worldwide.

are established, late-comers will be forced to commit disproportionately higher financial and management resources to establish their presence in the Chinese market.

It is expected that a complete overhaul of the financial system and a maturing capital market in China will lay the foundation for a more thorough engagement of European financial intermediaries in China. Therefore, capital flows other than FDI are expected to rise markedly also.

With the expected economic development in China, ODA disbursements on as massive a scale as happened in the past will become less justifiable. Many nations will appear to be more in need of assistance. But, given the distinct regional disparities in China, the persistence of poverty and the strategic as well as economic importance ascribed to China, substantial amounts of ODA will probably continue to flow in its direction.

The current situation, according to which China enjoys net inflows of capital from the major West European economies through all the main channels of economic interaction (maintaining trade deficits with China and transferring capital by means of FDI, commercial as well as governmental lending and ODA), is therefore expected to prevail and to become even more pronounced in the future.
Appendix 1: Development of actually used FDI in China by selected European countries 1985–2000 (in million US$)

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Source: Guojia tongji ju [National Bureau of Statistics], Zhongguo duiwai jingji tongji nianjian (China Foreign Economic Relations Statistical Yearbook), Beijing, various years.

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