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Summary: China's potential involvement in the eurozone crisis has triggered a wave of speculation about the political, economic, and strategic implications of China "buying up" or "bailing out" Europe. Prime ministers from Greece to Hungary have been touting Chinese bond purchases as votes of confidence in their countries' finances for well over a year. Yet the reality has so far been less dramatic. China did not swing in behind the European Financial Stability Facility. On the EU's part, there has been no sign of major concessions being offered to China in the hope that this will smooth the way for Chinese cash. The broader state of EU-China relations will depend significantly on how China and the EU deal with each other through a period that is not just an economic crisis for Europe but an existential one.

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A Europe that Can Still Say No? China and the Eurozone Crisis

by Andrew Small

China's potential involvement in the eurozone crisis has triggered a wave of speculation about the political, economic, and strategic implications of China "buying up" or "bailing out" Europe. This comes on top of previous rounds of debate about leverage that Chinese foreign direct investment (FDI), the lure of the Chinese market, and the burgeoning EU-China trade relationship may provide over the EU for Beijing. This speculation has been fanned by leading figures in Europe and China. Chinese Premier Wen Jiabao made a statement in September that seemingly linked support for the eurozone to the EU granting China "market economy status" (MES). Klaus Regling, chairman of the European Financial Stability Facility (EFSF), paid a visit to Beijing in October, soliciting Chinese contributions at a sensitive juncture in the evolution of the crisis. Prime ministers from Greece to Hungary have been touting Chinese bond purchases as votes of confidence in their countries' finances for well over a year.

Yet the reality has so far been less dramatic. China did not swing in behind the EFSF. From the limited amount of information available, its bond purchases appear to be skewed heavily towards the "safe" core bond issuers in Europe rather than support to the more distressed periphery. Chinese FDI in Europe remains very modest, at barely 0.2 percent of the total inflow.[1] More recently, Chinese officials have moved from cultivating ambiguity about their potential involvement in eurozone rescue packages towards actively dampening expectations. On the EU's part, there has been no sign of major concessions being offered to China in the hope that this will smooth the way for Chinese cash.[2]

So why so much noise? Why so little action? And has anything of consequence really taken place at all?

The $3.2 Trillion Question

The rationale for Chinese involvement in the eurozone crisis is clear enough. The EU is China's largest export market[3] and Beijing doesn't want to see it fail. While China may have been able to use a domestic stimulus package to

[1] "Chinese Direct Investment in Europe," Thilo Hanemann, Rhodium Group, October 26, 2011, p2

[2] "No China concessions to invest in EFSF" - Sarkozy aide, 31 October 2011 http://www.reuters.com/article/2011/10/31/eurozone-china-france-idUSL5E7LV-0VP20111031

[3] See statistics at http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/countries/china/

keep its growth rates intact through the financial crisis, the Chinese economy — and the network of supply chains in Asia in which it is embedded — are not in any sense decoupled from Europe.[4] China has been looking to diversify out of its reliance on dollar-denominated assets, both to hedge risk and to improve returns on its vast reserves. European bonds, and other European assets, are the natural place to turn. Moreover, as China tries to rebalance its economy and Chinese companies look to move up the value chain, the brands, technology, and expertise available in Europe make it an attractive investment destination — all the more so when Europe's economic woes should reduce the political resistance to any influx of Chinese money. Lastly, the crisis has provided a window of opportunity for China to bring up and press home its longstanding asks of the EU: the granting of MES and the lifting of the arms embargo. Beijing has also been discussing possible concessions from the Europeans at the IMF[5] (if the Fund were to be the mechanism through which China provided financing) though this has a less radioactive quality than the two issues that have hung over EU-China relations for nearly a decade.

From the European side, the explanation is even more straightforward. After a period of resisting the prospect of outside funding, the perceived need for a "bazooka" to hold the markets at bay and the political and legal wrangling over various financing mechanisms has ultimately shifted the EU's stance. With its $3 trillion of foreign exchange reserves,[6] China is the most obvious point of call. Japan is the only other country whose forex holdings exceed those in the eurozone itself[7] (though it is worth noting that, together, Russia, Brazil, and India would come close to Japan's $1.3 trillion of reserves).[8] The situation has been even more acute for individual countries and companies. China has at points seemed like the only potential white knight with the scale of deployable resources capable of keeping bond yields down, shoring up infrastructure projects, or rescuing imperiled European companies.[9]

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"Better to Save Wenzhou than Ouzhou (Europe)"

So far, however, the inhibiting factors have proved more powerful. For China, this has partly been prudential: the State Administration of Foreign Exchange (SAFE) and, to an even greater extent, China's sovereign wealth fund, the Chinese Investment Corporation (CIC), have been under close domestic scrutiny ever since some ill-fated early investments in the United States. While they have actively sought ways to increase returns and to diversify holdings — the rationale for the creation of a sovereign fund in the first place — risky European bonds have understandably been viewed with trepidation. Yet it is harder to make the case that uncertainties alone, rather than political considerations, explain China's caution over the EFSF. Public opinion in China, insofar as it can be ascertained, is hostile to the idea of what would look like a still-developing China bailing out decadent Europeans who have been living

[4] See Asian Development Bank papers, "Production Networks and Trade Patterns in East Asia: Regionalization or Globalization?," Prema-chandra Athukorala, No. 56 | August 2010, http://aric.adb.org/pdf/workingpaper/WP56_Trade_Patterns_in_East_Asia.pdf, and "The Ties that Bind Asia, Europe, and United States," Soyoung Kim, Jong-Wha Lee, and Cyn-Young Park No. 192 | February 2010, http://www.adb.org/Documents/Working-Papers/2010/Economics-WP192.pdf

[5] Reuters, "Politics Stymie China's EU Aid Offer," November 11, 2011, http://www.reuters.com/article/2011/11/11/us-china-europe-idUSTRE7AA1Q820111111

[6] See People's Bank of China, Gold and Foreign Exchange Reserves, http://www.pbc.gov.cn/publish/html/2011s09.htm

[7] See Ministry of Finance, Japan, International Reserves/Foreign Currency Liquidity, as of November 30, 2011; http://www.mof.go.jp/english/international_policy/reference/official_reserve_assets/e2311.html

[8] See International Reserves of the Russian Federation, http://www.cbr.ru/eng/hd_base/mrrf/main_7d.asp?C_mes=09&C_year=2010&To_mes=10&To_year=2011&mode=&x=30&y=12, Banco Central do Brazil, International Reserves, http://www.bcb.gov.br/?IR20120103, and Reserve Bank of India, Foreign Exchange Reserves, http://www.rbi.org.in/scripts/WSSView.aspx?Id=16573

[9] See "The Scramble for Europe," European Council on Foreign Relations, http://www.ecfr.eu/page/-/ECFR37_Scramble_For_Europe_AW_v4.pdf

beyond their means.[10] Without a saleable story for the Chinese public — a meaningful political concession from Europe — Beijing has been reluctant to take any serious steps in that direction. And even as they point to public opinion, it has been clear that Chinese officials themselves are also of a mind not only that Beijing's support should have some strings attached but also that China deserves a measure of recognition that it was their economic model, not the West's, that proved more resilient through the crisis.

Yet in Europe, the idea of concessions has been treated with skepticism. It is still not evident to many Europeans that the EU actually *needs* external financing at all[11] — and not if it comes at a political price. Certainly, none of the options on the table have been thought worth it. For a host of reasons, the lifting of the EU arms embargo would not even have been considered in this context.[12] The granting of MES is another matter, since it is a depreciating asset for the EU: China achieves the status automatically at the end of 2016 under the terms of its WTO accession protocol.[13] The prospect of offering MES early to China was dangled informally by the Europeans in the lead-up to the last EU-China summit with a view to seeing what Beijing might offer in return.[14] But it is also one of the few obviously strong cards that the EU has to play in its economic negotiations with China, and it is not yet clear that the deal makes sense. Suggestions around the time of the Cannes G20 summit that China might be granted some European-backed gains at the IMF — increased voting rights and the inclusion of the yuan in the IMF's special drawing rights (SDR) currency unit — were also dismissed.

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In fact, far from seeing the euro crisis as necessitating a rebalancing of the economic relationship in China's favor, European officials have continued to seek new areas of leverage. In common with many other countries, the EU has been faced with market access, subsidy, and intellectual property rights issues on such a scale that it has felt obliged to shift its trade strategy in order to address them.[15] For instance, while the growth in Chinese FDI affords influence for Beijing, it also provides opportunities for the EU to take advantage of China's growing desire for access to Europe as an investment destination. By comparison with other comparable markets, such as Japan and the United States, the EU has traditionally been less closed and less politically sensitive for Chinese investments. But the view in the EU has moved in favor of seeking to enforce some measure of reciprocity on China's part, in areas such as government procurement.[16] And while the public mooting of a European Committee on Foreign Investment in the United States by certain European Commissioners[17] may not have a plausible legal grounding, it is indicative of the mood. While Chinese financing and Chinese investment is undoubtedly welcome, Europe is also uncomfortable about it, doesn't feel desperate enough to make political concessions, and isn't even backing away from a toughened stance in the economic relationship.

The Politics of the Euro Crisis

This does not mean, however, that all the to-and-fro has been without significance.

[10] Reuters, "Beijing risks public backlash if it rescues Europe," November 3, 2011, http://www.reuters.com/article/2011/11/03/us-china-europe-newspro-idUSTRE7A236S20111103

[11] Bloomberg, "Juncker: Euro Area Doesn't Need China's Money," October 30, 2011, http://www.newsmax.com/FinanceNews/juncker-euro-china-debt/2011/10/30/id/416207

[12] *EU Observer,* "EU to keep China arms embargo despite massive investments," January 5, 2011, http://euobserver.com/884/31592

[13] This has been challenged in a recent article, Vox EU, "Is China a Market Economy?," Bernard O'Connor, October 27, 2011, http://www.voxeu.org/index.php?q=node/7345 but most experts consider the 2016 deadline to be real: see e.g. "Myth or Reality? China's Market Economy Status under WTO anti-dumping law after 2016," Policy Papers on Transnational Economic Law, December 2011, http://telc.jura.uni-halle.de/sites/default/files/telc/PolicyPaper34.pdf

[14] Interviews with European officials, Brussels, October 2010

[15] Reuters, "EU sends warning to China with 10-year trade strategy," October 22, 2010, http://www.reuters.com/article/2010/10/22/eu-trade-future-idUSLDE69L17820101022

[16] *New York Times*, "In Search of Leverage With China," November 22, 2011, http://www.nytimes.com/2011/11/22/world/europe/22iht-letter22.html?pagewanted=all

[17] AFP, "Commissioner Wants Foreign Investment Review Board," February 16, 2011, http://www.eubusiness.com/news-eu/economy-invest.8mz

First, while Chinese FDI flows have so far been modest, their political impact has still been notable. This has not always been positive — the Polish road-building contract was a high-profile disaster — but other instances such as the saving of Volvo have redounded to China's benefit. Opinion polling shows the first signs of Chinese popularity in Europe moving back in a positive direction after its steady decline appeared to be a secular trend.[18] FDI growth rates are also high — 2011 is likely to double the 2010 figure,[19] all the more notable in a context of economic stagnation. Countries are also well aware that these flows of Chinese money will not be determined by a purely commercial calculus. China's willingness to politicize economic and trade relations remains undimmed — Norway saw its salmon exports crash 70 percent in the early months of 2011 following its award of the Nobel Prize to Liu Xiaobo and the subsequent introduction of new "health inspections" at Chinese ports. For the most part though, Chinese money is being seen as a rare bright spot in an otherwise bleak economic landscape. The most recent indications were that SAFE was creating a Europe-specific investment vehicle within a new $300 billion fund, a fact reported soon after the CIC head, Lou Jiwei, announced separate plans for a program of investment in European infrastructure. This is going to win China more friends than it loses.

Second, the opacity of what is actually going on, especially in the secondary market for European bonds, means that both the European and Chinese sides have a measure of deniability: European states can claim Chinese confidence in the security of their bonds even if there is not much buying to substantiate it,[20] and China can play along, knowing that this is cheaply bought political credit. Equally, unless Beijing is caught up in a default or takes a large position in a transparent special investment vehicle, Chinese officials remain relatively free to increase their holdings discreetly without taking any real risks with their domestic public opinion. In some respects, the leverage this provides over individual member states is greater than would be afforded by placing several hundred billion euros in the EFSF. There are discernible, if modest, shifts in the political behavior of certain countries, some of which have been notably more reluctant to support the initiation of anti-dumping measures in the EU's Article 113 committee as China's economic influence has grown.

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Third, the end-game for the euro crisis is still unclear. In scenarios that involve an urgent need for external capital, European sniffiness about the terms under which China would bring its forex reserves into play may evaporate. While it is impossible to imagine any scenario under which the arms embargo would be on the table, economic concessions — including MES — are not out of the question. This cuts both ways though. On a certain scale, China would have some hard choices to face about whether it was willing to help stabilize its, and the world's, largest market or whether it would hold out for a quid pro quo in the context of an urgent crisis.

Nevertheless the euro crisis — even in the event of some of the most catastrophic outcomes — does not change certain fundamental facts about Europe's future economic relationship with China. European companies cannot afford to lose their technology and intellectual property to Chinese companies, get outfought in their home markets by subsidized Chinese firms, and remain shut out of predictable access to the second largest economy in the world. Strategic considerations for European economic security now loom far larger than when the main issue on the table was cheap textile imports. Aside from the measures that the EU itself

[18] *Spiegel*, "Will China's Rise Spoil the Transatlantic Relationship?," September 23, 2011, http://www.spiegel.de/international/world/0,1518,788109,00.html, and *Transatlantic Trends*, http://trends.gmfus.org/

[19] "Chinese Direct Investment in Europe," Thilo Hanemann, Rhodium Group, October 26, 2011, p2

[20] For a good example from Spain, see p3 "The Scramble for Europe," European Council on Foreign Relations, http://www.ecfr.eu/page/-/ECFR37_Scramble_For_Europe_AW_v4.pdf

will take to address this, Europe is already finding common cause with others who are in the same boat in their dealings with China.[21]

The Europeans have also demonstrated to China that they will not be terminally inhibited as political and security actors over the course of the crisis. Beijing was surprised by the willingness of at least some European states to press ahead with initiatives such as the Libya intervention despite the strained economic conditions. As one Chinese diplomat put it: "superpowers can walk, talk, and chew gum at the same time. China could never manage a crisis of the proportions of this one and at the same time start a war with a neighboring country — let alone win it."[22] Recent months have undoubtedly seen the eurozone's struggles consume more political attention: the EU-China summit itself was one of the meetings postponed in October to make way for an extended European crisis conclave. But the prospect remains that a more capable EU will ultimately emerge from the crisis, and China is not going to risk kicking Europe while it's down: the broader state of EU-China relations will depend significantly on how China and the EU deal with each other through a period that is not just an economic crisis for Europe but an existential one.

It would be delusional to pretend that a broader power shift is not underway, and that the euro crisis has not affected it. Moreover, with projections that Chinese investments in the West may hit between $1-2 trillion by 2020,[23] deeper transformations in EU-China relations are still to come. But heightened presence and exposure in Europe for China will not simply translate into a clean tilt of the power balance in its favor. As Beijing has found during the EU's deepest crisis in decades, for the moment at least, it is still dealing with a Europe that can say no.

About the Author

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About the Embassies Dialogue on Asia

The Embassies Dialogue on Asia was launched by the German Marshall Fund in the fall of 2011. Organized by GMF Transatlantic Fellow Dr. Daniel M. Kliman, it brings together young American experts on Asia, diplomats from Asia-Pacific embassies, and European diplomats in Washington with portfolios encompassing Asia to create a unique venue for informal discussion. The Embassies Dialogue on Asia is part of GMF's Asia Program, which addresses the implications of Asia's rise for the West through a combination of convening, writing, strategic grants, study tours, fellowships, and partnerships with other institutions. For more information, see http://www.gmfus.org/asia.

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[21] Interviews in Washington and Brussels, September and November 2011

[22] Meeting in Brussels, December 2011

[23] Rhodium Group, "An American Open Door? Maximizing the benefits of Chinese Foreign Direct Investment," May 4, 2011, http://www.rhgroup.net/reports/an-american-open-door-maximizing-the-benefits-of-chinese-foreign-direct-investment