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China and Europe in the eurocrisis

By Jonas Parello-Plesner, Senior Policy Fellow, European Council on Foreign Relations

Summary: *China and the EU are economically tightly linked. The eurocrisis thus has an impact on China since the EU its largest trade partner and export destination. This analysis suggests that China so far has stayed with public commitments to helping Europe but hasn't purchased in huge amount of indebted European countries' public debt. China seems like other investors to have followed a risk-averse strategy. Rumblings by some about a financial 'Munich-agreement' with China are thus overblown. Yet when it comes to direct investments in Europe, China and Chinese companies have perceived the eurocrisis as an opportunity to buy European companies. Here there is a huge growth in Chinese investments inflows. This fits with a new phase of the Chinese going-out strategy and the Chinese ambition of moving up the value chain. The eurocrisis has led China to entertain tighter relations with individual member states where investment deals are brokered. This has in some cases reinforced China's influence with some member states and reinforced the existing structural splits inside the EU hampering the development of a coherent policy on China. Yet EU's policy on China is multi-faceted and in some areas particularly on trade and climate change, the EU is presenting a tougher negotiation stance than previously. This, among other subjects, gives ground for transatlantic cooperation.*

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China has a fundamental interest in seeing the euro crisis recede as it is dependent on the EU for the largest part of its exports. All through the eurocrisis, China has been consistent in voicing support for the euro and for individual countries in distress; for example through numerous visits of its top leaders to Europe such as:

- Premier Wen visited Greece in October 2010 and explained that "China will undertake a great effort to support euro zone countries and Greece to overcome the crisis.". The amount of public debt bought at that and later occasions is uncertain but major investment deals notably in the port of Piraeus were also concluded during the visit.
- President Hu Jintao visited Portugal in November 2010 and voiced the readiness for "concrete measures to help Portugal overcome the global financial crisis". The news coverage assumed this translated into purchases of Portuguese bonds.
- Vice-Premier Li Keqiang visited Spain in January 2011, with similar news of confidence and according to news sources a willingness to buy-up Spanish sovereign debt.

Yet the actual numbers on bond purchases are shrouded in uncertainty by both China and Europe. China does only publish the total amount not the exact composition of its foreign exchange reserves. In accordance with that policy, it has never officially provided figures for its stake in public debt financing in Europe. The European Central Bank does not – in contrast to the US Treasury (the TIC data) - keep a public tracking of the nationality of foreign investors in the debt market.

Furthermore, there is a difference between the Chinese announcement at high-level visit and the actual purchasing of sovereign debt from the country. A visit does not necessarily coincide with the issuing of bonds. The Chinese statements can thus be seen as general pledges. As a result of both opacity on the Chinese side and the EU's own lack monitoring of European bond purchases, it is hard to know how present China really is in Europe's debt. The opacity of the exact scale of buy-ups will continue to be employed by China to its advantage.

So the following is based on assumptions through some of the scant data available. The new European rescue fund, EFSF has geographical indicators with Asia as a separate category of purchasers. In 2011, Asian investors bought 40 percent of the issuances. Japan, which is transparent on its purchases, makes of 50 percent of this. The assumption is then that China takes up around 40 percent. This would be roughly a net purchase of euro 5.6 billion in the EFSF. The Spanish Treasury, as the only one in Europe to this author's knowledge, also provides geographical indicators where China is lumped together with Asia and a host of other countries. If China acquired 40 percent (in line with its estimated EFSF-ratio of purchase) of the Spanish debt in 2011 in its regional category then it amounts to 2 billion

euro. And look at the Greek negotiations with major creditors on its debt restructuring, China wasn't to be found at the table thus also limiting the amount of Greek debt that China could feasibly hold.

Still, it also has to be taken into account that market estimates, again based on assumptions, put Chinese holdings of European bonds at 25 percent of its currency reserves. Just to maintain that level, would mean that China at least purchased around 80 billion euro of bonds in 2011. Yet these purchases are more likely to have been directed towards triple AAA-rated countries like Germany than towards the highly indebted and higher risk countries. Thus, what can be inferred is that China hasn't been the red knight or game-changer in the eurocrisis by massively purchasing Europe's debt either at national level or in the joint rescue fund (EFSF), where the initial ambition in the late fall of 2011 was to leverage the facility up to a trillion with outside financial assistance including China. This never materialized.

This is because the top priority for China is risk-aversion. Beijing is seeking stable and secure returns on foreign currency reserves; it burnt its fingers by investing in Wall Street in 2007 through its sovereign wealth fund (China Investment Corporation) and some would argue also by holding a too large portion of dollars relative to other currencies in a period when the US is employing quantitative easing as part of its monetary policy leading to dwindling returns. Also, with Chinese public awareness on the rise and the country's wealth colloquially baptised the 'blood and sweat' of the Chinese people, many Chinese netizens are questioning why China has to bail out 'lazy' Europeans at a time when social inequality is rampant in China. Wen Jiabao's remarks that helping Europe is in China's best interest are partly meant to placate this Chinese blog-fuelled dissatisfaction that would rather see Wenzhou than Ouzhou saved[1].

An additional complicating factor for China is that its currency reserves are declining for the first time in years, and 2012 could turn out to be a bumpy year economically. China might need to draw on its reserves to pull up growth to the magical 8 per cent that will help ensure a smooth political transition at the end of the year.

This helps explain the tight balancing act to which Chinese leaders have committed, showing some public support for the EU's currency ills while showing an equal dose of risk-averse

[1] Ouzhou is the Chinese word for Europe and Wenzhou is the home of venture capital in China where financing has become tighter.

reluctance at throwing too much money into the EU's piecemeal solutions. For example, the head of China's central bank, Governor Zhou, stated that China's helping hand to Europe amounted to not reducing 'the proportion of euro exposure in its reserves' — hardly the same as a massive purchase.

Yet this doesn't rule out additional Chinese financial support. The most likely scenario is that China will put additional money into the EU through an international body such as the IMF where Chinese support is also contingent of discussion with other stakeholders in that organization.

Even though China seems to favour risk-aversion when it comes to buying euros and bonds, it is more than willing to accept a stake in Europe's crisis by buying up companies. Rather, it saw the euro crisis as an opportunity for investments and mergers and acquisitions. In particular, Lou Jiwei, the head of China's sovereign wealth fund, is keen on boosting Chinese investment in infrastructure as China's contribution to Europe's future growth. Chen Deming, China's minister of commerce, also sees an opportunity: "European countries are facing a debt crisis and hope to convert their assets to cash and would like foreign capital to acquire their enterprises".

China at the end of last year purchased a large stake in Portugal's formerly state-owned energy company, which was sold off because of austerity cuts. Rover and Volvo are now Chinese-owned car companies. The largest British public water utility, Thames water, was sprinkled with Chinese money. Poland is - even after the unsuccessful highway project with Chinese state-owned company, COVEC- expanding cooperation with China Investment Cooperation on proposing assets that the Chinese side could invest in. The head of the Polish investmen agency remarked on the size of investments that 'the sky is the limit'. This rapid move into European acquisitions could well be the most startling change in the relationship between the EU and China in recent years. The level of investments surged past 10 billion in 2011 and was China's fastest growing FDI-destination. In comparison, the US is at half that yet also with a rising trend.

What does China's move into Europe mean for EU cohesion on China policy?

Europe faces a structural disadvantage in dealing with China. The EU is divided between member states with different economic interests and decision making involves various actors such as the Commission, European Parliament and the European Central Bank, not to mention new institutions such as the recently created rescue funds for the euro, EFSF and ESM. China, on the other hand, is still a unitary actor that can mobilise banks, wealth funds, money, and diplomacy to pursue its foreign-policy goals.

Even before the eurocrisis, China knew how to employ the EU's multi-level governance to its advantage based on differences between member states within the EU. For example, China knows that southern European countries aren't likely to be frontrunners on EU's human rights policy, and that free-traders in the north, spearheaded by the UK, Netherlands, Denmark and Sweden, will work to block strong retaliatory moves on trade that smack of protectionism. The EU's policy often ends up in a lowest common denominator which is comfortable for China. The eurocrisis and China's growing bonds with individual member states can reinforce that trend.

Still, greater Chinese influence on some member states is unlikely to fundamentally change EU's calculus. The lifting of the EU' arms embargo has been mentioned in the press as a possible concession following Chinese purchases. This is unlikely. Countries like Spain and Portugal were already in favour of lifting it receiving China's public commitment to their economic recovery. The real resistance in Europe lies with the UK. It still does.

Actually, and paradoxically, the eurocrisis comes as the same time as the EU is working to sharpen its tool box with strategic partners including China.

The EU has moved towards a policy of more reciprocity with China on the basis that China is no longer just a developing economy but also the world's second largest economy. Now, Europeans want trade and investment to be a "two-way street", as European Council President Herman Van Rompuy put it during his visit to China in May 2011– that is, they want equal market access and an improvement in economic imbalances in the relationship where intellectual property rights, markets access and technology transfer loom high on the agenda – just as these dominate the agenda for the US.

That can be seen in several cases of friction.

Chinese restrictions on the exports of rare earths are a source of concern for the EU and especially Germany, whose high-tech manufacturing sector is particularly dependent on the minerals. In July 2011, the WTO ruled that Chinese restrictions on the export of raw materials such as bauxite, coke and magnesium were unlawful following a joint complaint by the EU, Mexico and the US. This year, the EU joined the US in filing a suit against China's export restrictions on rare earths.

A second dispute between the EU and China was around anti-subsidy tariffs, with the first case ever by the EU on glossy paper in May 2011. This followed anti-dumping cases and was potentially less divisive among member states since anti-subsidies directly target acknowledged parts of the Chinese state-driven economic model like cheap loans, discounted allocation of land and tax incentives. This is a new tool to enforce free trade and new cases are likely, according to the EU's Trade Commissioner.

The EU is also proposing an instrument for greater reciprocity in public procurement such as infrastructure where China and other partners aren't as open as the European Union. The proposal is still under discussion in a draft version.

Lately, the emissions trading scheme for foreign airlines flying into the EU has been added to the list. The EU has put in place new legislation that makes foreign airlines liable to pay for CO2 emissions when entering European airports. This is part of the European Union's determination to meet climate change targets. Both China and the US have complained to the EU about these new rules. China has reacted with public denouncement yet also seems to have taken it to another level by blocking deals in China by Airbus, the European aircraft manufacturer.