China, the euro crisis and transatlantic cooperation

Testimony to the U.S.-China Economic and Security Review Commission

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The scale of China's involvement in the European debt crisis and its investments in Europe has been overstated. Internal politics, not external financing, has been the central challenge for the eurozone, and while Chinese FDI in the EU is increasing at a rapid clip, the volume remains modest. China has been nervous about being exposed to risky bonds on the eurozone periphery and is still cautious about the reaction to any major expansion of its investments in Western markets. As a result, although Beijing has suggested concessions from the EU that might attract more sizeable economic support, neither the perceived need on the European side nor the desire on the Chinese side have been great enough to bring it about.

For the United States, the opportunities to coordinate with the EU on economic policy responses loom larger than the risks that Europe's need for Chinese money will act as a constraint. The EU faces a virtually identical set of challenges to the United States in its commercial dealings with China, and—despite the depth of the euro crisis—has been seeking new ways to gain leverage in its bilateral relationship. The recent introduction of a reciprocity clause that would limit access to public procurement contracts in Europe—a measure almost entirely focused on China—is indicative of recent efforts to toughen up the EU's stance. The EU has also launched free trade talks with virtually every major economy in China's neighborhood, an approach that some have privately dubbed "Asia-minus-one".

Transatlantic cooperation is already well developed in some areas, such as China trade policy, but there is a great deal more scope for the United States and Europe to align their broader economic responses to China, and their trade strategies in Asia. In particular, it will be important to ensure that the new wave of bilateral and plurilateral trade deals, such as the Trans-Pacific Partnership (TPP), are complementary in their effects. As Europe and the United States seek access to economic opportunities in the region, a degree of competition is natural. But closer coordination can ensure that these initiatives are mutually reinforcing, not least in shaping China's economic—and even strategic—environment.

China and the eurozone crisis

Beijing's anxieties about sovereign debt problems in Europe are longstanding, with Chinese leaders among the first to raise concerns about the situation in southern Europe with their EU counterparts. China has been keen to ensure the stability of its largest export market, and apprehensive about the potential spillover effects for the global economy. Yet the crisis has also presented some opportunities. Europe's economic troubles have—at least in theory—provided China with the chance to snap up technology, brands, and hard assets at reduced prices and reduced levels of political resistance. Beijing has been able to dangle the prospect of financial infusions to see whether it will result in any movement on its longstanding asks of the EU: the granting of market-economy status (MES)[1] and the lifting of the arms embargo. The possibility of Chinese financing being provided through the IMF has put new potential concessions on the table there too, including a rebalancing of voting rights and the inclusion of the yuan in the special drawing rights currency unit (SDR)[2].

The Europeans have not been averse to the prospect of Chinese money. Member states have been keen to tout statements of Chinese support—or even talks with China—as votes of confidence in their economies, with Greece[3], Portugal[4], Spain[5], Italy[6] and Hungary[7] among the most conspicuous examples. At the EU level, policymakers have been divided throughout the crisis about the involvement of outside funding, even from the IMF. But the need for a large war-chest to hold the markets at bay, together with the political and legal wrangling over various financing mechanisms, ultimately shifted the stance of the euro-group, and the European Council meeting in October 2011 gave the green light for leveraging the European Financial Stability Facility (EFSF). China is the only country other than Japan whose forex holdings exceed those in the eurozone itself, and Beijing and Tokyo were natural first destinations for EFSF head Klaus Regling after the summit.

So far though, this has not translated into any major commitment of financial resources, and there are no indications that China has taken on significant exposure to the riskier bonds. Total estimates for the proportion of Chinese foreign reserves that are held in euro-denominated assets range from around a fifth to a little over a quarter[8], most of which appear to be concentrated in higher quality bonds[9]. Estimates of Chinese holdings in EFSF bonds—where the data is somewhat more transparent—have varied between 10-20%[10] (less, for instance, than Japan). Although there have been offers of greater support, Beijing has made clear that this would largely be channeled through the IMF. While the lack of clear statistical information necessitates a certain level of educated guesswork, the general picture is still clear: no grand deals have been struck and Chinese involvement has been that of a normal market actor rather than a savior for the euro-zone.

The story for Chinese FDI is an even more modest one. Chinese state-owned enterprises (SOEs), private companies, and its sovereign wealth fund have all made a number of headline-grabbing purchases over the last couple of years, with Volvo (Geely), Medion (Lenovo), GDF (CIC), INEOS (Petrochina), port concessions at Piraeus (COSCO), and Elkem (China National Chemical Corporation) among the more prominent deals announced or concluded. The trajectory is certainly an upward one, with 2011 investments running at double the 2010 figures[11]. But the baseline is low. Total Chinese FDI stock in the EU was less than 0.2% in 2010[12], a $12 billion figure that compares with, for instance, U.S. FDI stock of ca. $1.36 trillion[13]. The projections for the coming decade are substantial[14], and the significance of even the recent Chinese investments has been magnified by Europe's straitened economic conditions – cash rich investors with readily deployable resources have been thin on the ground. But these are not yet game-changing investment flows.

Cautious China, wary Europe

The situation reflects ambivalence on both sides. China, for its part, has been treading carefully, keen to avoid catalyzing domestic or international opposition. Insofar as it can be ascertained, Chinese public opinion has been hostile to the idea of "bailing out" the "decadent" Europeans[15]. Moreover, the managers of China's vast forex reserves have been under close scrutiny for years and, while seeking to diversify out of their reliance on dollar assets and improve returns, have been relatively risk averse. China has also been judicious about expanding its investments in European companies (and indeed all of its investments in advanced industrial countries), nervous about making bad judgments or getting burned again politically. The EU has been seen as an easier destination than the United States, in part because it lacks a centralized process for scrutinizing and blocking investments on national security grounds[16] (in fact, none of the member states with these mechanisms have used them to stop Chinese investments either) but Beijing doesn't want to spook the horses. Although there have been suggestions that China is sneakily expanding its European investments by focusing on "soft" targets among member states, the data implies that its patterns are similar to those of other external investors. The UK, France and Germany have seen the highest number of deals. Sweden and Hungary—slight outliers to the normal pattern of EU inbound investment—join them in the top 5 destinations for Chinese investment in terms of value as a result of a single large deal each (Volvo and Borsodchem)[17].

On the EU's part, the view has been that external support for the eurozone is helpful but not strictly necessary, and certainly not important enough to merit political concessions. The IMF was only brought in as a junior partner for the first tranche of bailouts, and senior Europeans have been very sniffy about third-country support. Eurozone members (and, even more importantly, the ECB) have the financial wherewithal to address the crisis, with political obstacles far more pressing than any lack of resources. Individual members may have needed bailouts, but the eurozone itself has not, and there has been strong political pushback when anyone has misleadingly created the impression of Europe "begging" for support[18].

This is not to say that trade-offs with China could not be envisaged in the right circumstances. The prospect of granting China market economy status, for instance, was quietly floated before the 2010 EU-China summit. This is a waning asset for Europe, given that China will be granted it automatically in 2016 under the terms of its WTO accession protocol. While sticking publicly to the mantra that this is a conditions-based process, plenty of European policymakers see it as something that should be traded off for concessions from China. Financial support to the eurozone, however, is not the deal that anyone had in mind. The arms embargo is in a different category altogether. With China having made no progress on the human rights issues that were linked to its possible lifting, and with additional strategic concerns accumulating since previous discussions of the subject within the EU, this is not in any sense a live issue. Only a combination of politeness and opportunism prevents that from being made clear publicly.

Dealing with a more assertive EU

Despite Europe's straitened economic conditions, the EU has moved more in the direction of assertiveness than of accommodation in its trade policy towards China[19]. There are exceptions to this—some of the smaller member states have become more reluctant to support the initiation of anti-dumping measures against China in the EU's Trade Policy Committee, for example—but there has been a broader mood change in the last couple of years. Instinctive free-traders among the member states have increasingly become convinced that China, perhaps uniquely, requires the EU to take a more robust stance if any leverage is to be gained over a long list of bilateral disputes, and have been willing to consider measures that they would once have sought to kill.

Not all of the mooted initiatives have taken off. Two European Commissioners proposed the establishment of a European equivalent of CFIUS[20], claiming the backing of a number of member states, after an (ultimately unsuccessful) attempt by Xinmao to buy Draka, a Dutch fiber-optic cable company. An internal assessment has concluded that, since there is no legal basis on which a direct like-for-like body can be put in place, there is no immediate rationale to proceed, but it is an indication that Chinese investments will face increasingly close scrutiny. Other proposals have taken on real momentum. A reciprocity rule is being introduced that will give member states the option to reject bids from countries that fail to open their public procurement markets to European companies[21]. While the procedure can be applied to all countries that have not signed up to the Government Procurement Agreement (GPA), it has been drawn up with China as the principal target. Chinese companies would stand to lose access to the EU's $500 billion market unless China either joined the GPA or stopped its own restrictive practices.

The EU has also embarked on an ambitious set of free trade talks in Asia. Apart from the agreement concluded with South Korea last year, FTA talks have been launched with Japan and Indonesia, and full negotiations with India, Singapore, Malaysia, and Vietnam are underway. There is also a potential revival of the attempt to reach an agreement with ASEAN, building on some of the bilaterals. While these are not a direct response to the EU's disputes with China, they will certainly have an effect on the pattern of trade relations for its neighbors, whether reducing their anxieties about economic dependence on Beijing or providing new opportunities to attract investment from European companies that have faced growing difficulties in China. If combined with U.S. efforts, they even promise to lay the groundwork for a higher-quality trade framework in the region and beyond.

Implications for the United States

Any concern that Europe's economic difficulties would undermine transatlantic cooperation on China has so far been wide of the mark. Trade issues have undoubtedly been the area where the two sides have worked together most closely, with officials on both sides in regular contact. March 2012 saw the filing of another joint WTO case, this time on rare earths (the first case that also includes Japan)[22], and there has been close coordination over issues such as China's indigenous innovation proposals. The two sides have recognized the fact that they face almost exactly the same challenges in China—market access problems, IPR theft, forced technology transfer, and a number of sector-specific issues—and, as China's two largest trading partners, are in a far stronger position when joint approaches are taken.

There are areas, however, where closer collaboration would be beneficial. The EU and the United States have not always been on the same page on the broader strategic dimensions of their economic approach to China. This notably includes currency policy, where differences spilled over very openly at the Seoul G20 meeting, and regional trade strategy, where there has been little attempt to join up approaches. In some respects, it may be harder to forge consensus on currency policy than it was a couple of years ago but it is a good juncture to seek one on trade, although that too will be difficult. With the Doha round moribund, the agenda will now largely be driven by the next wave of major bilateral and plurilateral trade deals. Some of these, such as the proposed services plurilateral, could take place within a WTO framework, but others will—at least initially—be regional in nature, and Asia is going to be the main focal point.

There are some "competitive liberalization" benefits that will accrue even if the United States and the EU are not operating in a coordinated fashion but there are clear disadvantages. FTAs with the same countries—and there is already a high level of crossover—can be more ambitious if they are based on a broadly common approach, and will be stronger if they can avoid conflicting provisions. Active coordination on individual FTAs may be too much to expect[23] but they are increasingly becoming building blocks for a broader set of economic goals. If part of the objective of initiatives such as the TPP is to set an aspirational bar on issues such as IPR protection and standards that creates upward pressure on non-members such as China, it is going to be far more effective if it is underpinned by agreement between the world's largest economic powers. Any go-ahead club of like-minded countries looking to establish a trade framework that is going to be attractive enough for China to make some tough decisions in order to join—and face serious costs if it doesn't—should include the EU, the United States, and preferably Japan too if it is going to have the requisite economic weight.

Conclusion

The last few years have generally seen a convergence of transatlantic views on China and a greater appetite for cooperation. While Europe is sometimes caricatured as being slow to wake up to the significance of trends unfolding in Asia, on the trade front it has in some respects an even more ambitious agenda than the United States, and a good basis has already been laid for future transatlantic collaboration in this field. In addition, the new U.S.-EU dialogue on Asia, being established by Assistant Secretary of State for East Asian and Pacific Affairs, Kurt Campbell, should help to build stronger habits of cooperation in the political and security arena too.

The eurozone is not out of the woods yet, and the EU-China relationship has still to be tested in conditions where there are very substantial levels of Chinese investment at stake. In this sense it is premature to conclude that the last couple of years definitively reflect the future pattern of relations. But it does indicate that—as for other countries—the expansion of commercial and economic ties is as liable to lead to tension as it is to closer alignment. For the coming period at least, there is considerably more scope for the United States to extend cooperation with the EU in dealing with China than there is cause for concern.

Endnotes

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[10] The EFSF numbers can be found at: http://www.efsf.europa.eu/, which categorizes bond purchases by region, though this estimate is also based on the private assessment of a senior EFSF official.

[11] For statistics on Chinese FDI, I am hugely indebted to the excellent material produced by the Rhodium Group. See: Hanemann, T. (2011). *Chinese Direct Investment in Europe*: Rhodium Group, and their other forthcoming papers.

[12] See Hanemann *op. cit.*

[13] See Eurostat, Foreign Direct Investment Statistics: http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Foreign_direct_investment_statistics

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