China's stake in the euro crisis

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Chinese leaders had a packed Valentine's Day this year. Xi Jinping, the new leader-in-waiting, toured the US in an effort to develop a rapport with American leaders, while back in Beijing, Wen Jiabao hosted Herman Van Rompuy and José Manuel Barroso as part of the EU-China Summit.

The main question was whether China's Valentine gift would be a larger financial stake in Europe, at a time when the EU is struggling to secure the continuity of the euro. Wen signalled the possibility of increased support for Europe's ailing rescue fund, the European Financial Stability Facility, but added that China does not have the capacity to 'buy up Europe'.

In light of these recent events, discussing China's stake in the euro crisis calls for some preliminary myth-busting.

First, if China takes a larger stake in Europe's debts, it does not mean that Europe's free will is going to be sold off to China in a Faustian deal. Even though the US has a much larger debt with China, for example, no one is inclined to question whether US foreign policy is decided in Beijing. The same goes for Europe; fears that reaching out to China is akin to a 'financial Munich agreement' are overblown.

Another myth, relayed by the press, is that every positive word on Europe from a Chinese leader will translate into a buying of bonds. But when China says it has confidence that Europe will resolve the crisis and that China will do its part to assist, it does not necessarily mean that Chinese money will flow in. China discloses its total holdings of currency reserves, but these figures are not broken down into countries and currencies. And neither the EU nor its individual member states have sufficient monitoring systems to track foreign holders of treasury bonds. As a result, one way or the other, it is hard to know exactly how much European debt China holds.

Nevertheless, 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. China is also seeking to move beyond dollars in its currency intake, and a world without the euro would be a return to a completely dollar-dominated system.

The top priority for China in pursuing this interest is risk-aversion — and this is no myth. Hence 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 and by buying too many dollars relative to other currencies, with the former now showing dwindling returns as the US resorts to printing money. 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 blog-fuelled dissatisfaction.

An additional complicating factor for China is that its currency reserves are declining for the first time in years, and 2012 could 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 reluctance at throwing too much money into the EU's piecemeal solutions. For example, the head of China's central bank, Governor Zhou, recently stated that China's helping hand amounted to not reducing 'the proportion of euro exposure in its reserves' — hardly the same as a massive purchase. The announcement sends the message that Europe should work out its own solutions without waiting idly for an inflow of Chinese money. But at the same time it does not 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. This would presumably be in cooperation with other partners like Japan and the BRIC countries, meaning China would not stand alone with the risk. Yet here both the US and paradoxically also Germany are reluctant since it could enhance China's say in the IMF.

Still, China's support for Europe is not yet a done deal. A public commitment from China's leaders quoting actual figures would help dispel myths both in Europe and China and would allow ordinary Chinese currency earners to track where their funds go.

Also, while China might also favour risk-aversion when it comes to buying euros, it is more than willing to accept a stake in Europe's crisis by buying up companies. Chinese Commerce Minister Chen Deming said he looked forward to a sale of European assets, and China recently purchased a large stake in Portugal's formerly state-owned energy company, which was sold off because of austerity cuts. This rapid move into European acquisitions could well be the most startling change in the relationship between the EU and China in recent years — and is likely to significantly affect the relationship for many more years to come.

P.S.

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