

ABSTRACT

In early November 2011, the President of the European Commission (EC) José Manuel Barroso warned of a crash that would instantly wipe out half of the value of Europe's economy, plunging the continent into a depression as deep as the 1930s slump. It was a serious warning, and it was too little too late.

This policy brief examines these issues by taking a broader look into the retreat of globalization in the aftermath of the global crisis of 2008; that is, the context for the unfolding eurozone crisis, in which the risk of a "Lehman moment" is increasing. It was during these days of rude awakening that the region's think-tanks, observers and analysts began speculating if China will be the eurozone's white knight.

Today, the EU and China are each others' largest trading partners. In the Western media, China is often portrayed as awash with cash, primarily due to its large US\$3.2 trillion foreign exchange reserves. Nonetheless, China's reserves are for the most part invested in long-term sovereign debt instruments.

In the recent eurozone and G20 summits, Chinese investment could have been facilitated into the eurozone by (a) making it easier for Chinese firms and investors to acquire hard assets; (b) by recognizing China as a market-oriented economy ahead of the World Trade Organization's (WTO) scheduled date for doing so in 2016; (c) by accelerating reforms in international multilateral organizations (WTO, IMF, World Bank) in which Europeans have a disproportionate representation.

Unfortunately difficult decisions were avoided in the various summits. In the coming months, whether the challenges of the eurozone can be overcome will depend on how leadership in the eurozone and the international community can be mobilized to make the necessary decisions.

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The Eurozone Debt Crisis and the Role of China

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Introduction

In early November 2011, the President of the European Commission (EC) José Manuel Barroso warned of a crash that would instantly wipe out half of the value of Europe's economy, plunging the continent into a depression as deep as the 1930s slump. The result of such an economic shock would be the emergence of extremism and divisions within Europe, the former Portuguese prime minister told his German audience. "Just as the founding fathers had a vision of Europe after two devastating world wars, we must also now act with resilience and with vision towards a Europe that is strong but open," he said. "Now is Germany's time to show that it is fighting the cause of a strong, integrated and competitive Europe".¹

It was a serious warning, though designed and targeted at the German audience. The problem is that it may also have been too little too late. For two years, systemic and pervasive eurozone problems have been deferred or treated with partial solutions, and time is running out.

What specifically led to these very serious warnings in mid-autumn of 2011? And what would be the role of China in the rescue operations of the eurozone? This brief examines these issues by taking a broader look into the retreat of globalization in the aftermath of the global crisis of 2008 before turning its attention to the eurozone crisis. The brief then provides an overview of the evolution of the EU-China relations and considers the role and responses of China to the unfolding eurozone crisis.

¹ "Debt Crisis: Barroso warns that eurozone collapse could trigger Great Depression II," *Irish Independent*, November 11, 2011.

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Globalisation at Risk?

Economic integration occurs through trade, migration, and capital flows. Since about 1870, all these flows rapidly became substantial, driven by falling costs of transportation. This first wave was reversed by a retreat into nationalism and protectionism between 1914 and 1945. After World War II, trade barriers came down, while transport costs continued to fall. This second wave of globalisation benefited primarily the advanced economies. It was their “golden era”.

Beginning in 1980 many developing countries broke into the world markets for manufactured goods and services; concurrently, foreign direct investment (FDI) increased. This triggered the rise of the large emerging economies such as the BRICs. That era ended in fall 2008.

In spring 2008, the Baltic Dry Index, which has often been used as a short-hand for international trade, climaxed at 11,800; today, it lingers at about 1,800. In late October 2011, the WTO’s report said that weak growth and macroeconomic imbalances globally are “testing the political resolve of many governments to abide by the G-20 commitment to resist protectionism”.² The challenges are reflected in the financial sector, as evidenced by the market capitalization of more than 50 stock exchanges worldwide. It, too, peaked \$64.5 trillion at the end of 2007. After gradual recovery, it climbed to \$59.2 trillion last April. With the escalation of the eurozone crisis, it has fluctuated around \$45-49 trillion in the past month.

In the post-recession periods, stock exchanges and international trade typically picked up. This time, it is different. Due to the accumulation of debt, growth is likely to be sub-optimal in the advanced economies in the short- and perhaps even medium-term. Due to the stagnation in the

export markets and FDI sources, growth will also be relatively slower, though still solid, in the emerging and developing economies. To make things worse, the phenomenon of rising energy prices is here to stay after more than two decades of cheap energy. As downside risks are heightened, globalisation persists. The path of nationalism, protectionism and competitive currency devaluations was tested in the 1930s. Today, the stakes are far higher and more global.

The Unfolding Eurozone Crisis

The eurozone crisis initially seemed to come out of the blue, at least as far as Brussels was concerned. In March 2010, European Commission President José Manuel Barroso introduced the European Union’s 10-year economic strategy.³ *Europe 2020* sums up the European model of social market economy with a strong focus on environmental sustainability, said EU Council President Herman Van Rompuy. Only weeks later however, European leaders were feverishly putting in place an intervention mechanism to preserve stability in the region as Greece’s debt turmoil spread further afield.

Since May 2010, the eurozone has witnessed several efforts to restore fiscal sustainability. Some countries have opted for tough fiscal measures seeking to increase taxes or cut public spending. Still, other countries have put their faith in higher GDP growth rates, but that requires time which is rapidly running out. While other countries are able to raise funds through monetary issuance by their national central banks, the eurozone member states cannot.⁴ The European

³ Aiming at “smart, sustainable, inclusive growth,” the strategy proposed raising the employment rate of the European labor force, investing 3 per cent of GDP in R&D, reducing greenhouse gas emissions by at least 20 per cent, compared to 1990 levels, and reducing the number of Europeans living below national poverty lines by 25 per cent.

⁴ The national central banks of the Eurozone members are subject to the European System of Central Banks (ESCB). Since 17 EU states of the 27 EU states have joined the euro,

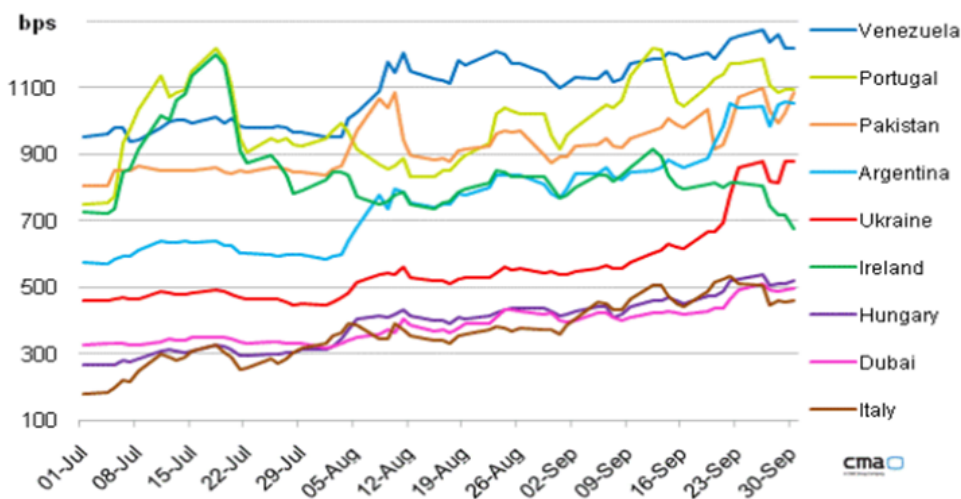
² *Report on G-20 Trade Measures*, World Trade Organization, October 25, 2011.

Central Bank (ECB) administers the monetary policy of the 17 eurozone economies; and it has the exclusive right to authorize the issuance of euro banknotes. As a result, eurozone economies – as Greece, Ireland, and Portugal are – cannot use devaluation to improve their competitiveness. Nor can the ECB engage in traditional measures to support ailing eurozone economies as long as it is focused on a “phantom threat of inflation” in an increasingly recessionary and deflationary environment. Despite all the rhetoric, the ECB will have few alternatives but to soon bow to pressure to print money to prevent a potentially fatal escalation of the eurozone debt crisis.

not in this list, its yields soared again soon after the list was published (Figure 1).

The turmoil was initially concentrated in small economies, each of which represents less than 3 per cent of eurozone GDP, and the problems could be contained. However, by autumn of 2011, the debt crisis had deepened to threaten the bigger economies. Continued talk of Greek bailouts, downgrades in Italy and Spain and concerns from the US about how the crisis is being handled did little to help market sentiment for European debt with the euro also facing selling pressure. The extensions of the EFSF helped the market, but only briefly as “euro hopes” were soon surpassed by “euro fears.”

Figure 1. The Top-10 Riskiest Sovereigns Worldwide, 3rd Qr 2011



Source: Global Sovereign Debt Credit Risk Report, 3rd Quarter 2011, CMA, Oct 6, 2011.

Initially, the soaring public debt levels in the eurozone were seen as a fall-out from the global financial crisis. If only the crisis had been averted, the argument goes, the debt levels would not be a problem. Nonetheless, the realities were far more difficult. After the third quarter of 2011, there were several eurozone nations in the top-10 riskiest sovereigns worldwide, namely Portugal, Ireland, and Italy. In Italy, the risk had increased dramatically since mid-2011. While Greece was

In early November, Italian ten-year bond yields topped the 7 per cent level widely deemed unsustainable, and its prime minister, Silvio Berlusconi, agreed to step down. Only days later, right before the election, Spain was forced to pay nearly 7 per cent on an issue of 10-year debt, the highest since 1997. Now investors are increasingly eyeing France – the eurozone’s weakest triple-A rated sovereign, as the next domino to fall in a sovereign debt crisis that is ever growing.

the ESCB could not be used as the monetary authority of the Eurozone.

In the past, public debt soared when it was used as the ultimate shock absorber, especially during times of war and conflict, such as World War I and II. In peacetime, public debt climbed during the bad years, but unfortunately, did not decline much in periods of growth. From the mid-1960s to the mid-80s, primary spending increased quite rapidly in the advanced economies, reflecting predominantly a surge in health care and pension spending.

The negative effects of the global financial crisis may diminish by the mid-2010s. By then, however, advanced economies will have to cope with the massive challenge of reducing debt ratios when pressures from health care and pension systems will put additional pressure on public finances. With large primary gaps and rising health care and pension spending, public debt would spiral out of control in the absence of fiscal adjustment. Under unchanged policies, the net debt-to-GDP ratio of the G7 economies would have reached 200 per cent by 2030 and exceed 440 per cent by 2050.⁵

Addressing these fiscal challenges in a comprehensive way would require pro-growth structural reforms, gradual and steady fiscal adjustment, stronger fiscal institutions and adequate and equitable burden sharing among the relevant stakeholders. And yet, the effort to stumble through the crisis has effectively mitigated attempts at such comprehensive reforms as evidenced by the current eurozone turmoil.

EU Paralysis at the G20 Summit⁶

Before the G20 summit in Cannes, French President Nicolas Sarkozy, along with German Chancellor Angela Merkel, had hoped to tout the

merits of the recent eurozone deal and to return to his original ambitious agenda for the G20.⁷ That all fell apart with political turmoil caused by Greek Premier George Papandreou's decision to call a referendum on the latest EU bailout package, which would effectively have been a referendum on Greece's membership of the euro, a decision that was reversed later. There was also a confidence vote in parliament on his leadership, which he narrowly survived. In late October, the eurozone summit agreed on a "comprehensive plan," which was in fact partial, but initially caused market euphoria. With their deal, eurozone leaders hoped to achieve three goals:

- To expand the liquidity facility from the current €440 billion (\$610 billion) to €1-2 trillion (\$1.4-2.8 trillion). However, the current deal will use leverage, which may contribute to turmoil in the future.
- To recapitalize the "systemically critical" banks inside the eurozone by €100-110 billion (\$140-155 billion). In reality, 70 of them must raise €106 billion (\$150 billion) by mid-2012, which may be challenging as the region may already be in a recession.
- To increase Greek debt reductions from the current 21 per cent to 50 per cent. The second Greek bailout plan, whose costs amount to €130 billion, may be back on track, for now. But Greece alone will consume at least €500 billion (\$700 billion) in 2010-20, in order to avoid default.

Meanwhile, other eurozone challenges – misguided fiscal policies, inadequate monetary

⁵ Cottarelli, C. and Schaechter, A. (2010), Long-Term Trends in Public Finances in the G-7 Economies, IMF Staff Position Note, September 1.

⁶ This section was previously published as 'Euro-paralysis at G20 summit' in *China Daily*, November 9, 2011.

⁷ As the holder of the G20 and G8 presidencies, the ambitious French agenda, which President Nicolas Sarkozy hoped to initiate before the presidential election year of 2012, comprised efforts to reform the international financial system, address imbalances in global economic governance and regulate commodities markets.

policies (which the new ECB chief Mario Draghi is finally trying to change), the toxic assets of the ECB, inadequate structural reforms and growth policies continue to simmer. After two years of turmoil, European leaders have still failed to contain the eurozone debt crisis. Greece remains a problem, but Italy could crash the euro.

Even as Europeans found themselves in a crisis that they barely saw coming, trade and investment relations between the EU and China were soaring and growing ever deeper.

Evolution of EU-China Relations

Relations between the EU and China were established in 1975 and the two are each others' largest trading partners.⁸ In 2010, the EU replaced the United States as China's biggest trading partner as Sino-European trade, with a volume of \$217.3 billion, exceeded the Sino-US trade volume by some \$5.7 billion. European companies such as Airbus, Siemens, Nokia and Volkswagen, made the EU the fourth largest investor in China and China's most important supplier of technology.

Bilateral relations are governed by the 1985 EU-China Trade and Cooperation Agreement. Since 2007, negotiations have been underway to upgrade this to a new Partnership and Cooperation Agreement and there are already 24 sectoral dialogues and agreements, ranging from environmental protection to education.

Evolution of Economic Relations

At the end of the Cold War, relations with Europe were not as high a priority for China as its relations with the US, Japan and other Asian powers. However, China's efforts towards closer bilateral relations with the EU, and its interest in a multipolar system increased as economic contacts with the outside world grew. Although European leaders had imposed an arms embargo

on China after the Tiananmen Square events of 1989, they sought to ease China's isolation through continued economic contacts. Most importantly, China's growing economy became the focus for many European businesses and Chinese businessmen also began to make frequent trips to Europe. High-level exchanges ensued in the 1990s. Starting from a relatively low base, the EU-Chinese trade expanded even faster than the Chinese economy itself, tripling in a decade from \$14.3 billion in 1985 to \$45.6 billion in 1994.⁹ France, in particular, was leading the EU's effort for closer ties to establish a multipolar world and was the first, along with Russia, to establish strategic partnerships with China. After the Chirac era, the EU-China relations cooled down briefly particularly after China's cancellation of the annual EU-China summit in November 2008, in protest against French President Sarkozy's plans to meet with the Dalai Lama.¹⁰

Evolution of Trade Relations

Most of the EU-China bilateral trade is in industrial and manufactured goods. In 2009-10, EU exports to China increased by 38 per cent and China's exports to the EU increased by 31 per cent (Figure 2).¹¹

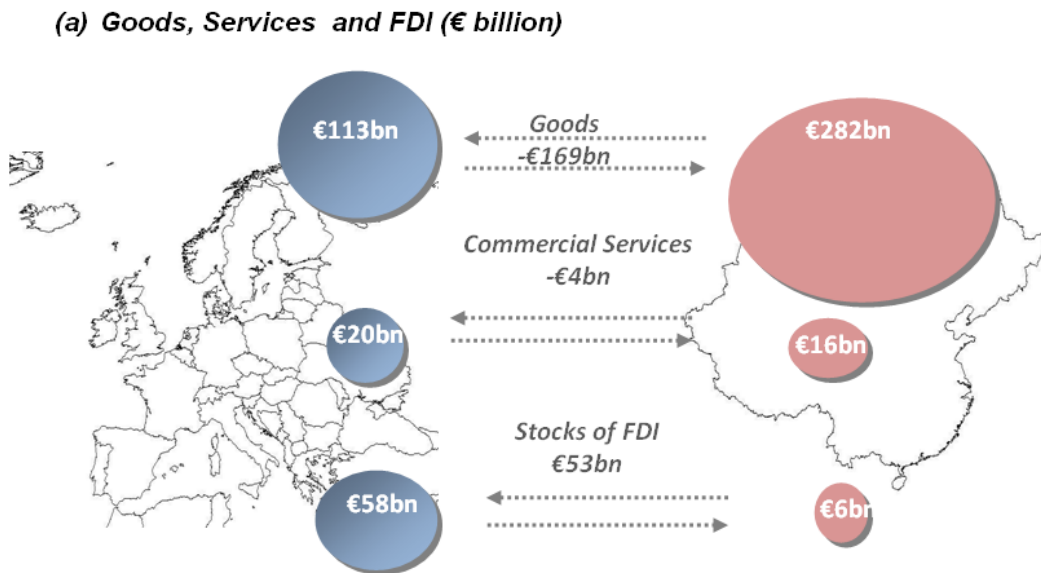
⁹ Despite occasional roadblocks, economic cooperation continued to deepen, with the EU's "New Asia Strategy", the first Asia-Europe Meeting in 1996, the 1998 EU-China summit and frequent policy documents advocating closer partnerships with China. Even following the financial crisis in 1997, EU-Chinese trade increased by 15 per cent in 1998. See Sutter, Robert G. (2008) *Chinese Foreign Relations* (Lanham, MD: Rowman & Littlefield Publishers), p.340-342.

¹⁰ However EU-China has experienced a cool down after China canceled the EU-China yearly summit in November 2008. This was apparently caused due to French President Sarkozy's plans to meet with the Dalai Lama. See "Business fears over Chinese-French rift," *Financial Times*, November 26, 2008.

¹¹ Friction has focused on few areas, including the dispute over textile imports into the EU. The dispute over textile imports into the EU (the Bra wars) with domestic European

⁸ "China beats US to become EU's top trade partner," *EU Observer*, October 17, 2011.

Figure 2. EU27-China Trade



In 2010, Chinese imports in the EU amounted to €282 billion, while the EU exports to China grew to \$113 billion. The EU's trade deficit in goods was €169 billion.

However, in the area of trade in services, Chinese commercial services in the EU amounted to €16 billion, while the EU services to China exceeded €20 billion. The EU's trade surplus was €4 billion. Chinese direct investment into EU was only less than €6 billion, while EU investment soared to more than €58 billion. China's FDI deficit ballooned to €53 billion.

Just before the EU summit in late October 2011, China surpassed the United States as the largest trade partner of the EU, exceeding that of the EU and the U.S. by €800 million and accounting for 13.4 per cent of the region's total imports and exports. In July, trade between China and the EU totaled €35.6 billion (\$49.4 billion), even as bilateral trade shrank for a second consecutive month.

manufactures losing out to cheaper Chinese imported goods. This conflict was resolved through negotiations.

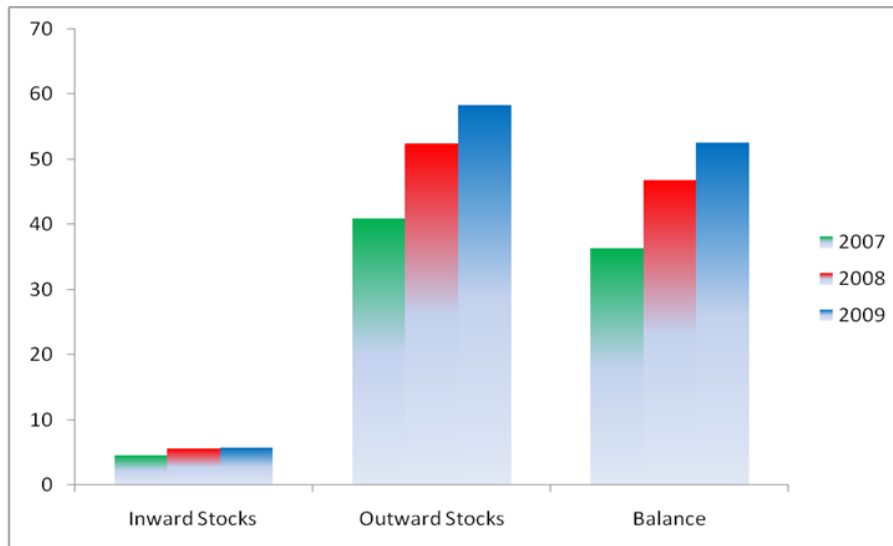
Meanwhile, China remained the EU's second largest export market.¹² At the same time, the EU reported a €12.2 billion trade deficit with China.

Along with concerns over intellectual property rights protection in China and EU firms' access to China's government procurement market, a major point of contention in relations between the EU and China remains the EU's arms embargo on China.¹³

¹² EU exports to China totaled 11.7 billion euros in July, up 12.3 per cent year-on-year, which is higher than EU's total export growth rate of 4.1 per cent. The EU imported €23.9 billion in Chinese goods, down 6.2 per cent from the previous year. But China still held the top spot as the region's import source, making up 17.4 per cent of the EU's total imports.

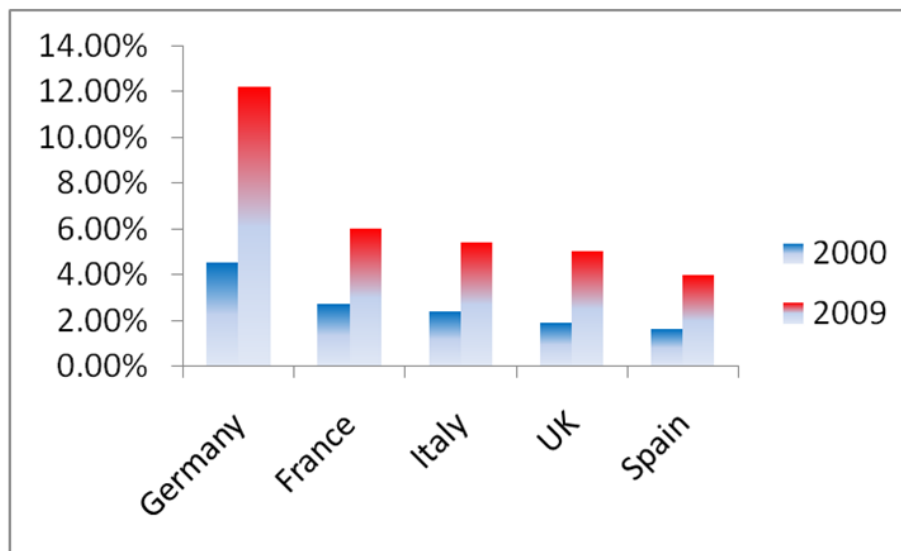
¹³ Unlike economic relations, progress in political and security co-operation was slower and occasionally hampered. Unlike the United States, the EU does not have comparable security interests in Asia or U.S.-style export controls for China. However, it continues to maintain an arms embargo, which was instituted after the Tiananmen Square events in 1989. While the embargo remains, China buys much of its arms from Russia, and the embargo may not be as tight as thought. High Representative Catherine Ashton put forward plans for lifting the embargo in 2010. Ashton argued that "The current arms embargo is a major impediment for developing stronger EU-China co-operation on foreign policy and security matters." The plan was rejected then but is thought to still be on the drawing

(b) Foreign Direct Investments: EU27 with China (billions of euros)



Source: Eurostat

Figure 3. Exports from Major EU Countries to China Have Soared



Source: Eurostat

board. See "Ashton pragmatic on China in EU foreign policy blueprint," *EU Observer*, December 17.

China's largest trade partners in Europe are also the larger member states in the EU. Between 2000 and 2009, their combined exports to China more than doubled from just 13.1 to 32.6 per cent of the total (Figure 3).

In each case, exports to China have soared in the past decade. All seek to enhance and deepen their bilateral relationship. EU nations, such as Italy and Spain that compete relatively more in low-tech industries have been stronger advocates of anti-dumping actions against China. On the other hand, most support lifting the EU arms embargo on China, under certain conditions.

Germany. Germany is China's largest trading partner in the EU by far. The bilateral relationship has been dominated by commercial and economic links, though political and security problems are growing in importance. German delegations visit China frequently, as has Chancellor Merkel every year, as did Chancellor Schröder before her. Between 2000 and 2009, the exports of Germany to China quadrupled to €36.4 billion, accounting for 12.2 per cent of Germany's external trade.

UK. The UK is the third largest EU trading partner for China. It is not viewed in China as a key technology and manufacturing partner in the way Germany is. It has been the largest EU investor in China, though Germany now claims to have overtaken it. Between 2000 and 2009, UK exports to China more than doubled to €5.7 billion, accounting for 4 per cent of its external trade.

France. Since 2004, "global strategic partnership" has served as a framework for relations in political dialogue, economic exchanges, cultural, scientific and technical cooperation etc. France has the largest Chinese community in Europe. France has been a leading advocate of lifting the EU arms embargo on China. Between 2000 and 2009, the exports of France to China more than doubled to €7.9 billion, accounting for 5.4 per cent of its external trade.

Italy. Italy's objectives include increasing market share in China for Italian products and attracting Chinese investment to Italy. Due to cheap Chinese products (e.g., textiles, shoes), China has been perceived as a "threat" to Italian jobs and standard of living. Chinese immigration is a significant issue. While Italy has consistently been against awarding Market Economy Status to China, it has supported lifting arms embargo. Between 2000 and 2009, the exports of Italy to China more than doubled to €6.6 billion, accounting for 5 per cent of its external trade.

Spain. Spain is interested in improving its balance of trade and opening up sectors of the Chinese economy. However, it has a low profile in Beijing, although rising in importance. Trade with China has been proportionately small for Spain's economic size. Spain has been strong advocate of anti-dumping actions, especially on footwear, but the government has repeatedly stated its full support for lifting the EU arms embargo. Between 2000 and 2009, Spanish exports to China almost quadrupled to €2 billion, accounting for 6 per cent of its external trade.

The White Knight to the Rescue of the Eurozone?

With China's increasing economic links to various EU countries, and as the debt crisis situation deteriorated rapidly in the eurozone, an intense debate ensued on the possible role of China as the white knight. Only months before, Italy's finance minister Giulio Tremonti still wrote about the threat of China's "reverse colonization" of Europe.¹⁴ However, the tone changed dramatically as markets began to demand rising yields to purchase Italy's sovereign debt, which was expected to exceed 120 per cent of GDP by the close of the year, a ratio second only to Greece in the eurozone. In a curious reversal, Tremonti began to court China in order to attract

¹⁴ "Italy turns to China for help in debt crisis," *Financial Times*, September 12, 2011.

Chinese investments. He was not alone; many European leaders are now seeking closer “strategic relations” with China, just as they are courting other large emerging economies, such as India, Brazil, and Russia.

Meanwhile, other European leaders warn against what they perceive as concessions to China. While the eurozone may be desperate for outside investors, some others fear that Brussels or the leaders of individual eurozone nations or both would offer China political concessions in return for economic assistance. In this regard, the key problem is the rescue fund, known as the European Financial Stability Facility (EFSF). For months, European leaders had been pushing the idea of a “big bazooka”; a multiple increase of its liquidity facility, perhaps even up to €1-2 trillion that would finally calm the market turmoil. By the eve of the EU summit of October 26, 2011, the consensus was that the bailout fund was simply too small. The fund's lending capacity of €440 billion was not even close enough to prevent the spread of contagion to the core, which includes Italy and Spain.¹⁵

At the EU summit, the European leaders, under the leadership of President Sarkozy and Chancellor Merkel, agreed to leverage the rescue fund because they could not agree on how to increase it.¹⁶ “If we in Europe organize the stabilization of the euro in such a way that we

¹⁵ European leaders agreed that the EFSF would explore two plans to increase its remaining firepower from about €250bn to €1,000bn. One would be to offer investors insurance on selected government debt while the other would create a special fund in which countries such as China could invest.

¹⁶ As it was soon realized that finding investors to boost the fund's lending capacity to €1 trillion might not be as simple as initially thought, they deferred the problem to the G20 Summit in Cannes, France. The quest for financial support, in turn, compelled the leaders of the crisis economies to approach Beijing. That was a red flag to those euro interests, which, along with U.S. unions, regarded the RMB as undervalued and prefer faster and more substantial appreciation to push their own exports.

allow states to exert political influence from outside, then we are making a tremendous mistake,” said Hans-Peter Keitel, president of the Federation of German Industry.¹⁷

At this point, China was seen as a likely contributor to the eurozone’s bailout fund but the scope of its involvement would depend on

European leaders satisfying some key conditions. Any Chinese support would depend on contributions from other countries and Beijing expected to be given strong guarantees on the safety of its investment. China hoped to assist because the eurozone is its largest trading partner, but this support was predicated on the interests of Chinese people.¹⁸

With \$3,200 billion in foreign exchange reserves, a quarter of which are believed to be held in euros, China was seen to be willing to contribute between \$50-100 billion to the EFSF or a new fund set up under its auspices in collaboration with the International Monetary Fund (IMF).¹⁹ The drive for EFSF investors has highlighted Europe’s growing reliance on major emerging economies - and also China's increased influence on the world stage.²⁰

¹⁷ “Raising Money for the Eurozone: Warnings Mount against Concessions to China,” *Spiegel*, Oct 31.

¹⁸ According to Professor Li Daokui, an academic member of China’s central bank monetary policy committee, “The last thing China wants is to throw away the country’s wealth and be seen as just a source of dumb money.” He added that Beijing might also ask European leaders to refrain from criticizing China’s currency policy, a frequent source of tension with trade partners. See “China could play key role in EU rescue,” *Financial Times*, October 27, 2011.

¹⁹ Ibid. President Nicolas Sarkozy of France welcomed the prospect of a Chinese contribution to the Eurozone rescue package. “Our independence would not be put into question by this,” he said in a television interview. “Why would we not accept that the Chinese had confidence in the Eurozone and place a part of their surpluses in our funds or our banks. Would you rather they placed it with the US?”

²⁰ One condition China might ask for is that its contribution be at least partly denominated in renminbi, which would

Some Europeans see a “scramble for Europe” taking place as China purchases European government debt, invests in European companies, and exploits Europe’s open market for public procurement.²¹ From their viewpoint, crisis-hit Europe’s need for short-term cash is allowing China not just to strike cut-price deals but also to play off member states against each other and against their own collective interests, replicating a strategy it has already used in the developing world. In particular, the European Council for Foreign Relations (ECFR)²² believes that the expansion of China’s presence in Europe is creating new fault lines within Europe and making it much harder to implement the more coordinated and tougher strategy towards China that the EU was beginning to develop. As Europeans compete with each other for Chinese business, they are reducing their chances of collectively negotiating reciprocal access to Chinese markets. Starting with a set of assumptions, they focus on three scenarios.²³ (1)

protect its investment against currency fluctuations. China would buy euro-denominated bonds but repayments would compensate for any changes in the value of the renminbi, which has appreciated nearly 20 per cent against the euro in the past three years.

²¹ The very title of the ECFR paper, “The Scramble for Europe” portrayed the pre-crisis Tremonti’s characterization of the Eurozone as an innocent continent, such as Africa in the late 19th century, which was being swept by neo-colonial forces from the East. ECFR saw in the crisis an opportunity to seize the crisis to foster integration across the fragmented euro nations. See François Godement and Jonas Parelo-Plesner with Alice Richard (2011) “The Scramble for Europe,” European Council on Foreign Relations, September, 2011.

²² See John Fox & François Godement (2009), *A Power Audit of EU-China Relations*, A Policy Report, European Council for Foreign Relations, April 2009.

²³ In their *Rescuing the euro: What is China’s price?* (forthcoming, ECFR, November 2011), François Godement and Jonas Parelo-Plesner believe that (1) China (among Asian and other economies) wants to invest money away from the dollar, has an interest in preserving and growing exports in Europe and fears the global bust that would follow a deep European recession or systemic crisis. (2) But China is also perceived as deeply risk-averse, and

In the best case, the eurozone’s rescue fund (EFSF) saves the region and China shifts some currency reserves towards the euro. (2) In the medium case, IMF comes to the rescue and China seizes the opportunity to offer Renminbi funds, transferring exchange risk to the European borrowers. (3) In the worst case, EFSF fails to contain the crisis, the IMF focuses on the rescue of the peripheral economies, major economies are swept by a crisis, and creditors get the driving seat.

All three scenarios have provided fodder for media and think-tank speculation in the past few weeks. However, realities are complex. The first scenario is invalid because it is predicated on the idea that the eurozone crisis is only one of liquidity or solvency. The second scenario is predicated on the notion that the IMF can and will rescue both the peripheral and the core economies of the eurozone, which – at least with current IMF funding – is either highly unlikely or simply impossible. The third scenario is also unlikely because the IMF would need additional funding to rescue the peripheral economies from some of the core economies, whose economic challenges it would have to ignore. Furthermore, neither China nor the other BRIC economies are likely to support the eurozone unless the core economies in the region do the same and unless certain other conditions apply (see the last section).

The EU would have more leverage in dealing with China, the other BRICs and creditors, if the region would be more united and transparent in its borrowing process. However, the current

particularly unenthusiastic about the sort of domestic political uncertainty and institutional complexity that Europeans are creating for themselves – both in domestic politics and in their byzantine institutional set-ups. (3) China will therefore “help” Europe if Europe helps itself. This means setting up a convincing argument and guarantees for outside investors. (4) The US has found such a modus vivendi with China on debt. Europe has yet to get to such a level playing field.

economic turmoil makes political unity less viable. The problem is that it is no longer possible to underestimate the eurozone's economic problems, which are pervasive and systematic.

Europe's 'Too Big to Fail' Economies

According to ECFR, there are currently two key groups of EU economies, vis-à-vis economic and political attitudes to China: the frustrated market-openers (Germany, UK, France, Netherlands), and the cash-strapped deal seekers (the Southern European crisis economies, Eastern European transitional economies), while the rest (Austria, Ireland, Belgium, Finland) are between these two camps (compare Figure 4). In reality, the groups and the underlying economic environment are far more complex. Instead of stated or observed attitudes, it is more useful to focus on hard data – the countries' GDP, gross debt (per cent of GDP) and current account balance (per cent of GDP) – which may also have greater predictive value. The GDP serves as a short-hand for bargaining power, whereas indebtedness and the current account balance point to the constraints over that power. This exercise reveals four different strategic groups of European nations (Figure 5).

- (1) Fiscally-responsible Northern states within the eurozone (Germany, Netherlands, Finland)
- (2) High-deficit/debt Southern eurozone economies (Greece, Portugal, Italy, Spain), which suffer from current account deficits and soaring gross debt.

Despite their differences and diversity, these groups are fairly similar; and the latter also includes the UK, a country not in the eurozone. However, there are two additional groups.

- (3) Privileged small eurozone economies such as Luxembourg, and non-eurozone economies (Sweden) which enjoy current

account surpluses and moderate gross debt;

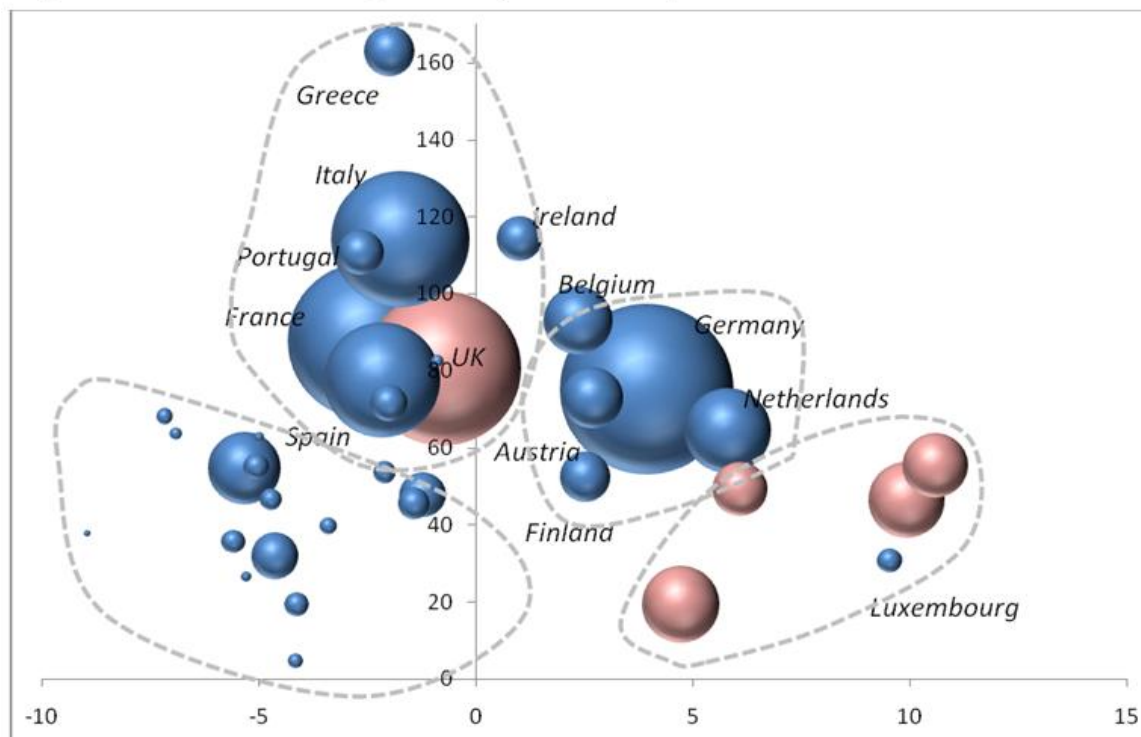
- (4) New member states (Poland, Romania, Czech Republic), which comprise primarily transitional or emerging Eastern European nations and which have relatively small GDPs, and suffer from current account deficits but have not yet accrued substantial gross debt.

Except for Luxembourg, the former represents relatively wealthy non-eurozone economies which seek to optimize their strategic maneuverability in the changing Europe. In turn, the latter represents relatively poor non-eurozone economies that hope to catch up with their EU neighbours in the footsteps of Estonia.

The economic status of each strategic group shapes its general attitude toward China, but it does not determine that attitude. Both Chancellor Merkel's Germany and Prime Minister Katainen's Finland share a similar approach to fiscal and monetary policies, but each has a different historical legacy in its approach to China. Cash-strapped economies, such as Greece and Spain may share a generic economic attitude toward China, but their bilateral political legacy is different. The same goes for the transitional Eastern European economies and the small circle of privileged small European economies, which still have their own currency and central bank. The generic strategic groups do have affinities; thus the envisioned two-speed Europe, with Germany and France in the driver's seat, underestimates future strains because France is an indebted deficit country and Germany is not.

What is worrisome is not the differences among the EU nations, which only reflects their diverse and heterogeneous histories, but the relatively substantial concentration of these economies among the high-deficit, high-debt nations, including major economies such as Italy and Spain, but, to a degree, even France and the UK.

Figure 5 The Strategic Groups of EU27, E2011*



* IMF data on EU27, by GDP, gross debt (% of GDP), and current account balance (% of GDP).

As the markets' unease will deepen, the Europeans will struggle for a bigger liquidity facility. The recapitalization of the major banks will be debated passionately. Greek turmoil will continue because cooperation between ex-PM Papandreou's Socialists and Antonis Samaras' conservatives is easier said than done.

In the past, the eurozone problems were resolvable because the peripheral economies – Greece, Ireland, and Portugal – each represented less than 3 per cent of EU GDP. However, if Spain or Italy, the two major “too big to fail” economies, fail to raise money at reasonable interest rates, the G20 will be forced to lead a coordinated response to avoid the adverse consequences on the world economy. Just a few months ago, Italy's Premier Silvio Berlusconi claimed there was no crisis in Italy, but even he had to accept highly intrusive IMF monitoring of

his government's promised reforms. That, however, is far from sufficient.

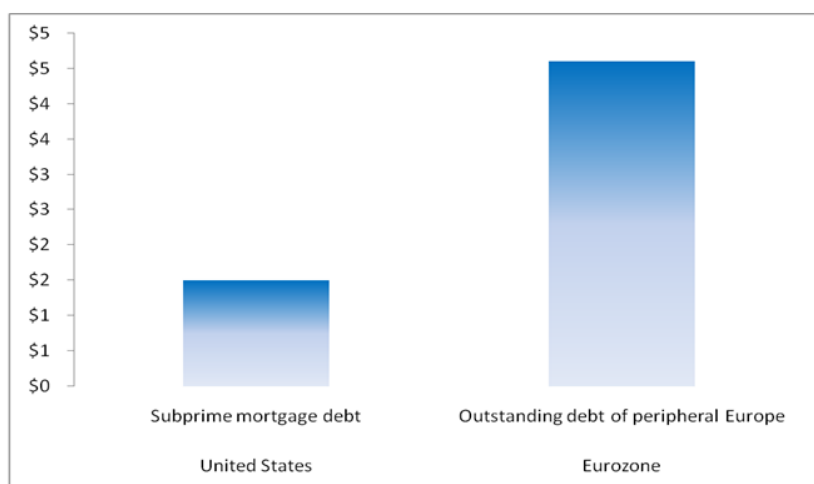
As in the case of the small euro countries, bailing out Spain and Italy would require covering their public financing requirements for three years. The associated loans would amount to about \$2.1 trillion. If the IMF were to fund one-third of the total, as it did in the case of the small peripheral countries, its share would amount to about \$700 billion, almost twice the current new lending capacity. In turn, the eurozone countries would have to raise \$1.4 trillion, which exceeds the available capacity of the current rescue fund by over \$1 trillion. Even if the bailout would be possible, any sudden stop of financing to Spain and Italy would cause a severe recession in these major economies and a spillover effect on the rest of Europe, the United States, and the BRICs. With \$850 billion in direct exposure and an additional \$1.8 trillion in indirect exposure (e.g., derivative contracts and guarantees), American

banks would be in harm's way too. Such developments would have adverse consequences worldwide. In the US, the "Lehman episode" took months; in the eurozone, it would require years. The stakes are higher: in the US, the subprime mortgage market peaked at \$1-1.5 trillion, whereas the outstanding debt of the peripheral Europe amounts to \$4.6 trillion (Figure 6).

January 2011. Earlier in the year, China signed multibillion dollar agreements with debt-ridden Spain to invest in projects ranging from energy to banking and oil. China has also agreed to enter into numerous business contracts with Greece, the most severely affected European country.

Naturally, Europe would like to see China, along with the BRICs, as the white knight.

Figure 6. Debt Threats in the U.S. (2008) and Peripheral Euro zone (2011)



* Based on data from IMF, Federal Reserve, Eurostat.

How Could China Support the Eurozone?

While we should still be mindful of the brutal historical legacy of European colonialism, contemporary Europe has played a vital role for and in the BRICs, vis-à-vis trade and investment, science and technology, finance as well as aid and assistance. In the long-term, the European markets and industries will continue to play a vital role for the BRICs.

China has already bought billions of euros worth of bonds from Greece, Ireland, Italy, Portugal and Spain.²⁴ In addition, investors from China and Hong Kong bought 6 per cent of the €5 billion initial issuance of the EFSF benchmark bond in

However, the bond market channel presents rising risks. According to a recent IMF report, half of the €6.5 trillion stock of government debt issued by euro area governments is showing signs of heightened credit risk.

In the Western media, China is often portrayed as awash with cash, primarily due to its large \$3.2 trillion foreign exchange reserves. Nonetheless, China's reserves are for the most part invested in long-term sovereign debt instruments, with around 60-65 per cent in U.S. dollar instruments, 20-25 per cent in euro assets, and the remainder split between other currencies. Only a small fraction is held in highly liquid short-term paper.

Prior to the EU summit, China, reportedly, was considering an investment of \$50-100 billion into the eurozone; 1.6-3.2 per cent of its foreign

²⁴ "Wen: China will continue to buy European debt, *EU observer*, June 27, 2011; "China: EU bailout leaves 'fundamental problems' unresolved," *EU observer*, July 8, 2011.

exchange reserves. Theoretically, longer-dated instruments could be liquidated, but it would not make much sense from the Chinese standpoint and could severely destabilize the markets. China could also accelerate the diversification of its reserves by investing more in euro assets. But even that would not be enough. In 2012 alone, the eurozone will need around €1.7 trillion (\$2.4 trillion), or 17.5 per cent of its estimated GDP, for refinancing. Most importantly, Chinese public opinion would not support such risk-taking. In the coming years, China must cope with its own domestic development needs and Chinese investors are mandated to seek long-term, high financial returns, within reasonable risk tolerance.

The eurozone is China's most important trading partner and takes up 20 per cent of China's total exports, which is slightly more than the US share in Chinese exports. It is also China's primary technology partner and key source of FDI. European multinationals have played a vital role in China's economic development. And yet, China has a stock of only €7 billion (\$10 billion) in FDIs in the eurozone; just 3 per cent of its total outward FDI stock as of 2010 (Figure 7).

The leaders of eurozone countries could facilitate Chinese investments into the eurozone in three ways:²⁵

- (1) Instead of paper assets, the eurozone could make it easier for Chinese firms and investors to acquire hard assets.
- (2) The eurozone could recognize China as a market-oriented economy ahead of the World Trade Organisation's (WTO) scheduled date for doing so in 2016.
- (3) The eurozone could be more willing to yield to concessions regarding the representation of China and other large emerging economies in international

multilateral organizations (WTO, IMF, World Bank) in which Europeans have a disproportionate representation.

Some or most of these conditions should be fulfilled for greater support by China and other BRIC economies. Additionally, they will seek for assurances for the security of their proposed investments and, naturally, they expect core eurozone nations to purchase eurozone debt.

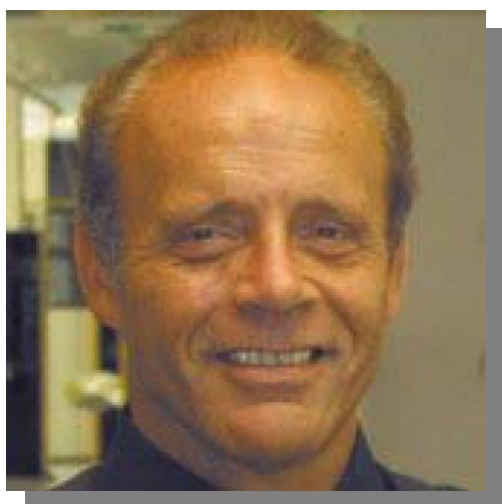
Today, the eurozone is struggling with half a dozen overwhelming challenges: misguided fiscal policies, inadequate monetary easing, insolvency crisis (Greece is only the beginning), a grossly inadequate liquidity facility, the need to recapitalize major banks, the central bank's toxic assets, as well as challenges in competitiveness and innovation.²⁶ In turn, the Chinese people are Beijing's first priority. The GDP per capita of the Chinese is still relatively low relative to European living standards. As long as China remains open and grows at 8-9 per cent per year, it can drive and support global growth significantly. But neither China nor the BRICs can bailout the eurozone economies because the challenges are too great, too pervasive, and too systemic. Just like China and the BRICs, Europe must stand on its own; or it will fall. The eurozone needs to mobilize all the political will and support to make the difficult decisions that have been avoided and deferred for too long.

²⁵ Steinbock, Dan (2011), "How Will China Support the Eurozone," CNBC, October 29, 2011.

²⁶ Steinbock, Dan (2011) "Why the Eurozone Crisis Will Deteriorate Before It Will Get Better," *EconoMonitor*, Roubini Global Economics, October 28, 2011.

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