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SAVING THE EURO: WHAT'S CHINA'S PRICE?

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SUMMARY

Although Europe needs external lending and the show of confidence it brings, its attempt to persuade China and other emerging economies to enlarge the resources of the EFSF is likely to bring only limited results. However, there are various other scenarios under which China and other investors may lend to Europe. The best case scenario from Europe's point of view is that it would increase the lending capacity of the EFSF or the ECB and turn them into a super borrower and lender. But this scenario is unlikely to become a reality because it requires a "big bang"-like reinvention of European public finance for which there is no commitment.

More likely is that the ECB will underwrite a new IMF fund dedicated to the support or rescue of European member states. This would mean a larger Chinese contribution in IMF decision-making. Alternatively, China could seek to lend to Europe in renminbi, thus transferring the exchange risk to the European borrower. Such a deal would also offer China an unprecedented guarantee against any depreciation of the euro. Finally, the euro could collapse altogether and the IMF could be called in – the worst case scenario. In any case, Europe should acknowledge the interdependence between it and China and therefore its need for external capital.

China has emerged as a potential contributor to solve the eurocrisis. At the European Council meeting of 24 October, it was decided to seek out China and other emerging countries to enlarge the resources of the European Financial Stability Facility (EFSF), the rescue fund earlier set up. Its head, Klaus Regling, has made the rounds of potential lenders and is reporting back to Eurozone ministers. But the initiative has sparked two competing debates: do we need China, and at what cost for Europe's independence? And if we do, are we offering the right terms to China and other external lenders?

How badly does Europe need China?

Whether or not Europe needs China or other external lenders depends on the extent of its own political unity. Its considerable private wealth, and a public debt-to-GDP ratio below that of the United States, not to mention Japan, imply that Europe should be able to take care of itself. But markets look not only at stocks but also at flows, and Europe's deficit, growth and current account indicators point downwards. The lack of clear-cut decision making and political cohesion adds to negative sentiment. Of all the world's integrated economic regions, Europe is the most open to outside goods, investments and immigration. Europe needs external capital to defeat the vicious cycle between public austerity and economic recession. It also needs a vote of confidence by its largest partners – and above all by China, the nation whose trade surplus with Europe has grown from €55 billion when the common currency was first introduced to a likely range of €160-180 billion in 2011 – the world's biggest bilateral trade imbalance.

If Europe does need a loan from China and other emerging economies with surplus balances, it is apparently not offering the right terms. Criticism of the Council's initiative and what is known of the EFSF enlargement formula illustrates several important points. First, a recently created fund incorporated as a private entity in Luxemburg and with limited individual liability for its European backers is not nearly equivalent to a sovereign guarantee. The leveraged insurance scheme thought up by the promoters of this plan has key deficiencies: the insurance applies only to the first tranches of a borrowing country's indebtedness. Nobody has doubts that European member states can pay back these first tranches. It is additional borrowing that is in question. And as market rates shoot up, reflecting a higher risk for lenders, the capacity of the fund to leverage this insurance is narrowing.

Ultimately, cash-rich nations such as China and other emerging countries are not looking for high rates of return in today's bloated capital market. At an interest rate of 25 percent, Greek bonds don't find buyers – while Japan, with a 220 percent debt-to-GDP ratio, sells its 10-year bonds with an interest rate under 1 percent. Investors look for safety first. Finally, the circumstances surrounding the birth of the initiative to enlarge the EFSF literally begged for a refusal by lenders: the short-lived Greek referendum drama unwittingly pointing out the unreliability of even unanimous Council decisions, the lack of lending commitments by core European economies and the fog surrounding solutions to reinvent the Eurozone and European solutions.[1]

Although Europe needs external lending and the show of confidence it brings, it is likely that the EFSF enlargement initiative will bring only very limited results. Other tools will soon be sought, which will again raise the issue of China's role alongside that of other potential lenders. There will be an agonizing debate in Europe about the new dependency this creates on China – a decidedly authoritarian rising power that has long-standing demands on Europe. The president of the Federation of German industry has pointed to those risks, while the (opposition) president of the Finance committee of the French National Assembly has termed the initiative a "commercial Munich".[2] There will also be a debate in China. On the one hand, it knows it needs to prop up its largest customer, which absorbs 23 percent of China's exports. On the other hand, it fears throwing good money after bad, and the political risk to China's leaders of gambling their foreign currency reserves, the country's treasure chest and insurance policy.

1 See Mark Leonard, *Four Scenarios for the Reinvention of Europe*, European Council on Foreign Relations, November 2011, available at http://www.ecfr.eu/page/-/ecfr43_reinvention_of_europe_essay_aw1.pdf

2 Hans-Peter Keitel, quoted in "*Raising Money for the Eurozone: Warnings Mount against Concessions to China*", Spiegel, 31 October 2011; Jerome Cahuzac, president of the French National assembly Finance Commission on France 2 TV, 31 October, 2011, video file available at http://www.francetv.fr/2012/jerome-cahuzac-ps-denonce-un-munich-commercial-8397

The debate, however, need not happen in this primitive form. As the liquidity crisis in the eurozone's public bond market is deepening – even Germany was unable to raise new lending on 23 November – it is clear that the weeks ahead will bring new emergency scenarios. Identifying short-term solutions and contributors to the Eurozone's liquidity crisis is like shooting at a moving target. There could be a Copernican revolution from the core of the Eurozone, leading to a federalist takeover of borrowing and budget processes in eurozone countries. Conversely, there could be a systemic failure of Europe's banks and credit, spreading to the global financial markets. These two scenarios would provide very different backdrops to a contribution by China and other surplus economies.

It is against each of these scenarios that the debate about the desirability of a Chinese solution and the issue of a Chinese "price" for this solution should be assessed. In the best case scenario there would be an appetite for European sovereign debt. In the worst case scenario, the European project itself collapses and creates and unwanted dependency on outside lenders.

Scenario 1: the eurozone as a new sovereign

The first scenario would see an immediate extension of the EFSF or the European Central Bank's own lending capacity, with matching contributions from Eurozone members (including European currencies pegged to the euro) and external partners. This would give Europe the time and the leverage to implement necessary institutional changes for budgetary and fiscal unity and discipline. Indeed, conditionality on the new extended EFSF is answered by a turn to tight fiscal and budget surveillance for eurozone economies – with targets adapted to the situation of each borrower, and sanctions built in the EFSF's terms of lending. In short, the EFSF, or the ECB, would become a European super borrower and lender, with unassailable guarantees.

The catch is that this outcome requires a convincing European commitment on resources – without insurance gimmicks. It assumes the present political problem behind the crisis – a lack of mutual trust within Europe regarding implementation of budget and fiscal coordination – is solved. Without this commitment and trust, outside lenders have no reason to commit themselves. In short, this scenario requires a "big bang"-like reinvention of European public finance, superseding the inch by inch political haggling that is still called the European or "Jean Monnet method".[3] But there is no doubt that such an outcome would have China and other external investors knocking down doors in order to lend to Europe. With political cohesion and resilient mechanisms for implementing decisions, the Eurozone's present debt load would be very manageable.

3 Ibid.

Scenario 2: a sovereign waving an IMF stick

Eurozone indecision and past weaknesses have created mistrust. External lenders will only operate on global terms, which also help political leaders of lending countries to shield themselves from the accusation of throwing good money after bad. This requirement in fact meets a uniquely European constraint: the Lisbon Treaty and German restrictions on direct intervention by the ECB in the primary debt market and on monetary creation to buy back debt. A creative solution is needed that would bypass the Treaty and German reservations without violating laws. The ECB could actually underwrite a new IMF fund dedicated to the support or if need be rescue of European member states. This fund would be managed by the IMF according to its rules and criteria. Nothing would prevent other IMF members from contributing additional resources, which would allow it to rescue a large economy. There may be a stand-off between China and the US on this fund. The US has indicated recently that its contribution towards a European solution could be "by sharing our experience and ideas" rather than "having the American taxpayer pay for every problem".[4] America is less forthcoming than Europe on the issue of further shares and voting rights for China inside the IMF, as this could lead to a loss of veto right for the US.

In this hybrid ECB and IMF scenario, Europe would delegate its contribution to the IMF and accept its rules and oversight. This would shield EU institutions from direct criticism, focusing the expected public opinion backlash against the IMF terms for any rescue. In this scenario, the price for a contribution by China would be political, and mainly paid for by the US, not Europe: a larger Chinese contribution via the IMF means a larger role in decision-making, via shares and voting rights. Europe has already conceded some of its influence inside the IMF to China and other emerging countries, but the US has yet to budge on this issue.

Scenario 3: The sovereign on Chinese crutches

China might play a wild card with Europe; it could seek to lend in Renminbi, thus transferring the exchange risk to the European borrower and even using the new London-based offshore Yuan market to raise "Euroyuans" for that purpose. The scheme was floated when Klaus Regling declared it possible during a press conference in China. Austria's central bank announced in early November an agreement with China to "invest via the People's Bank of China (PBoC) in Renminbi denominated assets", the first instance of such an agreement outside Asia.[5] Europe could become the vehicle for internationalising the Renminbi. Such a deal would also offer China an unprecedented guarantee against any depreciation of the euro – and a premium should the value of the Yuan move upwards.

This scenario would be for China an attractive alternative even to an IMF loan denominated in special drawing rights. But it would signal a decisive weakening of the euro as a global currency. In fact, economists consider borrowing in a foreign currency the "original sin" because it leads to uncontrolled risk. The long-term financial price for such a Chinese condition would therefore be very high. But this course of action requires no Treaty change, no joint guarantee, and no change of the ECB's limitations regarding quantitative easing or monetisation. These terms might be the price Europe would pay for refusing to change the governance of its public finances.

Scenario 4: a run for the lifeboats

Again and again, time has been lost. The EFSF is clearly under-equipped to take on the systemic crisis. Meanwhile, any political solution to the crisis will simply take too long to prevent dire market outcomes – the eurozone will have lost all traction on the debt crisis, given that its remaining creditor countries are even less likely, from a political standpoint, to engage in bilateral lending to their beleaguered partners. The IMF could therefore be called in. As of 24 November, it has already been asked to intervene by Hungary, a non-eurozone country, and has been tasked by the EU with direct oversight of Italian public finances. The IMF does not deal with the EU or the eurozone as such. Rather, it undertakes direct country-by-country rescue, each with different contributors and conditions. In any case, the IMF could not rescue the larger eurozone economies. The results in terms of image would be catastrophic and would stop any further steps towards economic integration inside the eurozone. The situation would be akin to previous financial crises in developing or emerging economies.

The true cost of a Chinese loan under these circumstances would become impossibly high from all points of view. External creditors could extract terms through the IMF which would give them the same power as they would have in a bilateral rescue. China could set even tougher terms and begin extracting implicit or explicit pledges regarding market economy status or human rights policies. The precedents – China's rather direct public diplomacy with distressed member states in 2008-2010 and its choice to announce publicly a $1 billion loan to Belarus without giving actual figures for lending to EU member states – are not reassuring. Perhaps the only way to address this situation would be to remind China of its own history: in 1917, its beleaguered northern rulers accepted a loan from Japan that was matched with territorial conditions.[6]

4 Deputy National Security Advisor for International Economic Affairs Mike Froman at Press Briefing, Cannes, November 3, 2011, available at http://www.whitehouse.gov/the-press-office/2011/11/03/press-briefing-press-secretary-jay-carney-deputy-national-security-advis

5 Press release by the Austrian National Bank, Vienna, November 10, 2011, available at http://www.oenb.at/en/presse_pub/aussendungen/2011q2/Copy_3_of_2010q1/pa_20111110_peoples_bank_of_china_and_oesterreichische_nationalbank_sign_important_agreement_today.jsp#tcm:16-241109

6 The Nishihara loans by Japan of 1917, against which China had to accept Japan's take-over of Shandong over Germany, are remembered as a national humiliation. See Joseph W. Esherick, "*Ten Theses on the Chinese Revolution*", Modern China, Vol. 21, n° 1, January 1995, p. 58.

An IMF solution, with or without the ECB

At present, Scenario 2 seems most likely. Relying on European funding and IMF governance, bypassing formal EU or German national law, it ironically requires neither major collective changes by Europe, nor is it conditional on major Chinese action.

Scenario 4 – the worst-case scenario – is the second most likely. It enacts the same solutions as Scenario 2, but without any of its creativity: the eurozone hasn't been able to muster pooling of resources for a large IMF vehicle, IMF ownership requires country by country rescues, external lenders come and go at will, imposing their additional terms, explicitly or implicitly.

Scenario 1 – the best-case scenario – is less likely to happen because it requires an urgent reinvention of Europe. Blueprints exist, but politicians also need to converge. At present, an expansion of the role of the ECB is opposed by Germany, which insists instead on control of budget and deficits at the level of member states. But if an agreement was struck with these requirements, China and others would indeed ask – or even beg – for lending opportunities, creating a new global dynamic.

Finally, Scenario 3, which is a complement rather than an alternative to other scenarios, is likely to be played out whatever happens, as China's most fundamental goal for economic security is to extend the range of its national currency.

In short, the conditions under which China and other investors may lend to Europe are going to be shaped above all by the European Union's moves in the next few weeks.

Acknowledging the interdependence

There could therefore be a new European relationship with China, acknowledging greater interdependence, or on the contrary a retreat to opposite perceptions of interests on both sides. The euro crisis has not created interdependence between the EU and China, which goes back a long way. It has just made this interdependence more visible and therefore the subject of heated debate in both Europe and China.

Between 2002 and 2011, the eurozone's GDP grew at an average rate of 2 percent while China's grew by 9 percent. During the same period, the value of China's global exports multiplied by six and the EU-China trade imbalance widened from €55 billion (with the EU25) to a likely €180 billion (with the EU27). Yet during the same time span, the euro has increased value with the Chinese Yuan, moving from a yearly average of 7.80 (2002) to 9.10 (as of September 30, 2011).

"Cherchez l'erreur", as the French say. Such a deep and long-lasting growth gap and trade imbalance can only lead to one of the following three developments. Firstly, it could lead to a massive readjustment of the exchange rate, an event which China's currency and capital control policies remain directed against. Secondly, it could lead to a further opening of the surplus partner to competition, which the deficit partner can hope to take advantage from by improving its own economic efficiency. (However, this ideal path of reform and opening up on both sides seems to be precluded by China's insistence on its status as a developing economy, clinging to the terms of its WTO accession a decade ago.) Thirdly, barring a positive trend of adjustment by Europe with other partners (which would somehow compensate the imbalance with China), it could lead to a counter-flow of capital from China to Europe. There is no fourth solution, except if one considers as a solution a massive European recession coupled with trade war policies aiming to shore up Europe's external accounts.

The European debt crisis has brought all of this into the open. The eurozone's and Europe's current account balances are dipping – pointedly in 2008 and again in 2011. Measurements differ – the IMF is more optimistic than official EU statistics.[7] But there is no mistaking the general trend. Of course, massive austerity and a recession would reverse the trend and obviate the apparent need for external capital, but at what true cost?

Gone is the time when Europe could avoid the appearance of dependence on China, and China could have the best of both worlds with Europe: a huge trade surplus without any adjustment measure. Both sides had become complacent, believing that Europe's overall balance obviated the need for adjustment and that China could push its trade surplus still further without consequences, barring public opinion or media grumbling in Europe.

Acknowledging the interdependence and therefore a need for external capital is a realist step for Europe. If we don't manage this issue collectively, the most distressed member states will manage it one by one, unilaterally and under conditions that will not be favourable. Political leaders and public opinion should not debate whether China is a bogeyman or a white knight. It is most likely neither, focusing rather on issues of its own making – such as bloated foreign currency reserves, its overreliance on exports and the difficulty of making further market reforms inside a basically authoritarian system. It is the solutions of our own making, and the terms we offer to actual lenders, that will make or break deals.

7 For the European source on current account balance until 2011 Q2, see Eurostat news release 128/2011 of September 9, 2011. For IMF source, see IMF, World Economic Outlook, at http://www.imf.org/external/pubs/ft/weo/2011/02/pdf/tables.pdf.

A potential China/EU/US debt triangle?

Additionally, a decisive push by Europe for new steps towards monetary and financial sovereignty will create new challenges, including with our best allies. Some of these challenges have already appeared in conflicts between the eurozone and non-eurozone member states. But an increase in capital flows from China, whether in the form of investment or lending, would also point to a triangle with the US in international finance. US Treasury Secretary Timothy Geithner has warned Europeans of the risk of dependence on outside creditors: "You don't want the fate of Europe to be in the hands of those who provide financing to the IMF".[8] The risk is real, as some of the four scenarios above illustrate. But Geithner's advice is surprising, coming as it does from the economy that has been most consistently dependent on Chinese lending – to the tune of $1.5 trillion, counting non-Treasury public assets held by China. Over the past two decades, while American private savings were much lower than Europe's, its growth rate has been twice as high.

A politically weak Europe would indeed face greater political risks than the US. In spite of the high level of its indebtedness to China, the US denies China market economy status, maintains a robust and still growing strategic presence in the Asia-Pacific, and is occasionally more proactive than Europeans on issues of political governance. A politically cohesive Europe could choose to challenge the easy access the US has to Chinese savings. This is not without risk: one could imagine a "divide and rule" strategy by China, playing on Europe's lack of direct involvement in East Asian security flashpoints. China, for itself, will increasingly seek to consume capital for its own domestic needs – stimulating flagging growth, creating social equity and preparing for an ageing population.

What lies ahead may therefore be a self-defeating financial triangle between China, Europe and the US, or it may be a G3 for growth. For the latter option to prevail, Europe must not fall back on the illusion that it can treat its financial issues within a closed zone. It must become a sovereign international financial partner, moving beyond the passive and incomplete global currency that we have lived with since 2002. This implies seeking a deal with China, the world's largest holder of currency reserves.

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8 Timothy Geithner in Wroclaw, quoted in Laurence Norman and Marynia Kruk, "Geithner Warns Over Divisions In Europe", Wall Street Journal, 16 September 2011, available at http://online.wsj.com/article/SB10001424053111903927204576574400653014170.html

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