China’s Strategy to Save the Euro: From ‘Active Support’ to ‘Wait and Hope’

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Abstract

The aim of this paper is to analyse China’s strategy in relation to the present and future of the Eurozone (EZ). This has been done in three steps. The first section presents an exhaustive summary of China's unequivocal public relations and financial support to the euro since its creation up to the current EZ sovereign debt crisis. The second explains why China has been so supportive of the euro. China favours a tripolar monetary system based on the US dollar, the euro and the Chinese RMB. With this aim China has been diversifying over the years into the euro making it by now ‘too big to fail’ from a systemic point of view. Finally, the third section focuses on how China might have changed in 2012 its strategy from ‘active support’ to ‘wait and hope’ that Germany’s crisis resolution strategy works. Berlin’s plan is to use market pressure to induce the EZ periphery to give up certain degree of budget sovereignty in order to create the necessary fiscal union for the survival of the euro. Beijing sees this as a risky strategy, but for now it has decided to collaborate.

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1. Introduction

Much has been said in recent times about China's willingness to rescue the euro. However, not much has been studied about its actual strategy. In the age of information, open editorials and public speeches by high profile policymakers, pundits and economists have considerable influence in shaping public perceptions. This is especially true in highly interconnected global financial markets where instant information can suddenly change investment decisions. Throughout the Eurozone (EZ) sovereign debt crisis (2010-2012), European policymakers have blamed the Anglo-American press and US and UK-based economists for scaremongering over the faith of the euro. The possibility of a euro break-up has been constant news in the openly euro-sceptic British tabloids but also in the editorially more balanced *Financial Times*, *The Economist*, *The New York Times* and *The Wall Street Journal*. By contrast, the Chinese Government, and its associated news agency *Xinhua*, have had a very different approach. Every time the euro has fallen into a danger zone, the Chinese leadership has counterbalanced widespread euro-scepticism in the markets by propping up the single currency with open public support.

Over the past years it has been widely publicised that China has supported the EZ with investments in debt bonds of troubled EZ countries. However, what has been overlooked by the literature is how China has also developed a communication strategy to steer market sentiment in favour of the euro whenever it was needed. While assessing China's financial support to the EZ, this paper will also focus on the public relations strategy developed by Beijing toward the single currency. By matching Chinese public (media and official) statements of support with the foreign exchange rate trajectory of the euro, it will be demonstrated that China has had considerable influence in sustaining the value of the European currency. In addition, it will also be argued that China has been increasing its collaboration with Germany in order to find a solution to the crisis. This is one of the reasons why China has gradually decreased its active financial support to the EZ periphery, and why in turn the euro has lost in value in the second half of 2012. For Berlin sovereign bond spreads are an effective pressure mechanism to introduce reforms in the periphery and achieve closer political union in Europe. Beijing on its part has accepted this strategy, although it has also shown its concern about the harshness of the adjustment measures advocated by Berlin.

The paper is structured in three main parts. The first presents a detailed recompilation of China's active support to the euro since its birth in 1999 until the first half of 2012. It will show how Chinese policymakers stepped in to sustain the value of the European currency every time it was under considerable market pressure during the EZ sovereign debt crisis (2010-12). The strategy has been two-fold. One, the Chinese leadership has used public statements and open editorials in the state-owned *Xinhua* news agency to show their confidence in the single currency, and two, they have accelerated their diversification moves out of the dollar and into the euro. China's behaviour has changed market perceptions on the euro, as recognised by financial heavyweights such as George Soros, who has openly recognised that China saved the European currency. The second part of the paper is more analytical. The main aim is to explain why China is supporting the euro and the European integration project at large. Several reasons are explored. China needs to diversify out of the dollar, so the crisis is a good opportunity to accelerate this process. However, this diversification means that China has already over $800bn in euro-denominated assets. Hence, it needs to protect the value of its national savings. In addition, the EU is China's most important market. Therefore it is in China's own national interest to stabilise the European market. And, finally, this crisis is a good opportunity for China to present itself before its European counterparts, especially Germany, as a reliable and trustworthy partner.

Following this logic, the third part of the paper shows that in 2012 China has decreased its financial support to the EZ periphery at the behest of Berlin. Germany’s strategy is to use this crisis to create “more Europe” on federal lines. By using the pressure of the markets, it is forcing the weaker EZ states to accept further pooling of sovereignty at European level. The Chinese leadership worries that this strategy might backfire, but so far it has stood by the strategy of its closest partner in the EZ and consequently it has reduced its active support to the periphery. This switch from ‘active support’ to ‘wait and hope’ that the Europeans solve their own crisis has pushed the value of the euro again down, which is arguably precisely what the EZ periphery needs to increase its competitiveness and repay its debt.

2. China's unequivocal support to the euro

The main objective in this first part is to document China's approach toward the European currency since its creation. The goal here is to present in a chronological fashion how Chinese policymakers' strong support to the euro has been consistent over the years, including during the recent euro debt crisis.

China welcomes the arrival of the euro

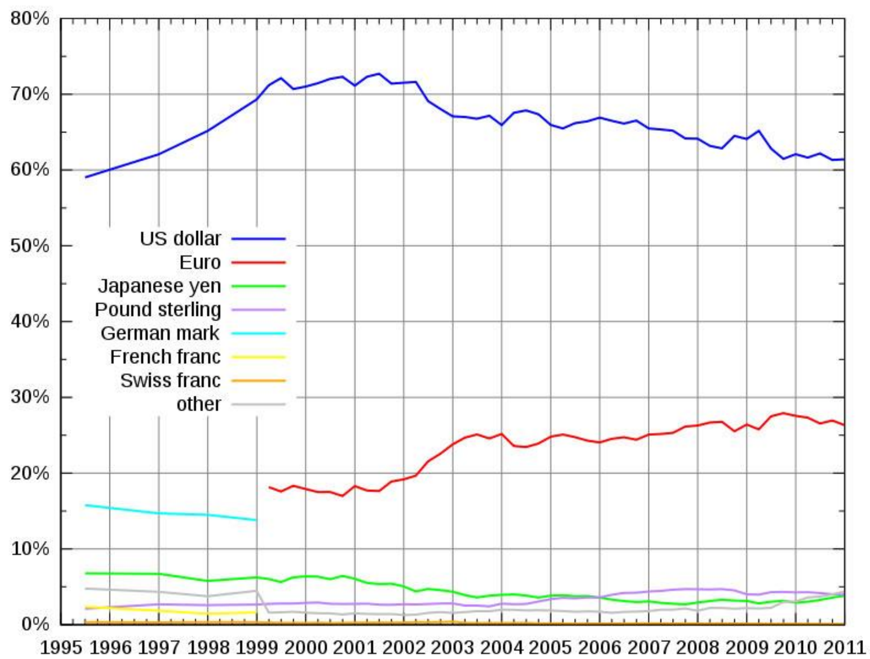
From the early days of European Monetary Union (EMU), the emergence of the euro as a potential challenger to the dollar was greeted favourably by the Chinese government. In 1999, year of the launch of the single currency, the Foreign Minister of China, Tang Jiaxuan, stated: "We believe that the birth of the euro will help advance the process of European integration and establish a more balanced international financial and monetary system" (Tang 1999). Chinese policymakers have never been completely satisfied with dollar unipolarity in monetary affairs and thus they welcomed the euro as a counter-balancing project with the potential to help them diversify their national savings in different currencies. For them, the euro would bring more choice and therefore more stability to the system. This belief was widely shared in East Asia, as Xu Mingqi notes:

> Generally speaking, East Asians were not as sceptical as Americans when the EU embarked on […] the euro. East Asians welcomed the euro basically for two reasons: the first was that it would be more convenient and efficient for them to do business and travel around the EU countries with a single, unified currency; and the second was the hope that the euro, backed by the EU's economic size and strength would eventually become an alternative choice of international currency vis-à-vis the US Dollar (Xu 2007:273).

This interpretation has been reinforced in subsequent years. In 2002, when the euro was physically launched, Xiang Huaicheng, the Chinese Minister of Finance, called for more diversification into the euro by saying: "It's better to put all our eggs in varied baskets rather than a single one. I might suggest to my colleagues in other government departments to buy more euros. Obviously the euro is getting stronger these days…no one will doubt the success of the euro" (MoCoC 2002). In 2005, the Chinese Prime Minister, Wen Jiabao, continued saying that a successful euro would bring a more stable system, and thus China would "support the role of the euro in maintaining international financial stability" (Wen 2005). During the same period the governor of the People's Bank of China (PBoC), Zhou Xiaochuan, declared: "We have long attached importance to the holding of a certain amount of euro assets" (*Xinhua* 2005), indicating that Chinese foreign exchange reserves should be invested in different currencies other than the dollar to avoid exchange rate risks.

With $3.2 trillion of foreign reserves accumulated over the past decade, diversification of currencies has always been one of the main aims of the Chinese government. In this regard the European currency has become the main alternative to the US dollar. This was acknowledged in 2007, still before the global financial crisis, by the deputy governor of the PBoC, Wu Xiaoliang, by saying that "with the economic development of the European Union and the stability of the euro, the increasing proportion of euros in reserves of central banks is an inevitable trend" (*Xinhua* 2007).

Figure 1: Global distribution of global foreign exchange reserves



Source: COFER, IMF

China's currency distribution of foreign reserves is a state secret, nonetheless in an article published in 2010 in the *China Securities Journal*, an official publication, unnamed managers from the State Administration of Foreign Exchange (SAFE), the state agency in charge of managing the foreign exchange reserves, disclosed that at the end of the decade (note that this was before the euro crisis) China's reserves were roughly similar to the global average (see Figure 1). 65% were in US dollars, 26% in euros, 5% in British pounds and 3% in Japanese yen (*Reuters* 2010).

China does not buy the 'euro-break-up' theory

While lingering in the background since the creation of the euro, the likelihood of a possible break-up of the EZ has resurfaced with force during the current financial crisis, especially since it became obvious in early 2010 that Greece was unable to meet its debt obligations. During that time reports and open editorials hinting at the possibility of a break-up of EMU were common place in the international financial media coming out of New York and London (Allen 2010; Harui 2010; Heaney 2010; Klaus 2010; Krugman 2010; Rachman 2010). Policymakers in Europe denounced that there was an Anglo-Saxon media campaign to undermine the single currency (*WSJ* 2010). While this might sound a bit too conspiratorial, the truth is that for longstanding euro-sceptics, coincidently a large number of them based in the US and the UK, the fiscal troubles of the EZ periphery – which are still acute as of the time of writing – only prove that they were right about the structural shortcomings of the EZ project. For many of them the Achilles heel of EMU is that, in addition to not being an optimum currency area, it is a currency union without the necessary federal fiscal budget to transfer funds from less hit to more financially troubled regions. For a number of commentators in the US and the UK the debt crisis in the EZ has reinforced their view that the euro has always been a bad idea with a finite duration.[1] Outspoken critics of the single currency across the Atlantic such as Martin Feldstein

[1] The pessimistic views on the euro by US economists in academia and the FED are thoroughly investigated by a European Commission paper by Jonung & Drea (2009) entitled: "The Euro: It can't happen. It's a bad idea. It won't last: US economists on the EMU, 1989-2002". A marked exception is Eichengreen (2007; 2009; 2011), who represents the euro-optimist branch among US mainstream economists.

have gone even as far as to encourage Greece to unilaterally leave the single currency and take a temporary "holiday" from the EZ (Feldstein 2010).[2]

This rather pessimistic outlook on the euro contrasts with the beliefs put forward by Chinese policymakers and commentators. For an overwhelming majority of Chinese policymakers, financial elites and scholars interviewed in China first in 2009, before the crisis, and then in 2012, in the midst of the crisis, the likelihood of an EZ break-up remains remote (although it must be said that in May 2012 the possibility of Greece leaving the euro had gained certain momentum in China). They acknowledge that by not having a full-fledged fiscal union there will always be doubts about the project, but a dismembering of the EZ is very unlikely. Some would even criticise Anglo-Saxon media, commentators and scholars for giving too much credit to this possibility (Zhou Hong 2009).[3]

Most policymakers and financial elites in China think that leaving the euro would be too costly economically and politically for any country in the EZ. Besides, they are convinced that the Europeans will deepen their integration process because this is the only way that they can maintain their influence in the world. For a lot of these elites it comes down to a survival instinct. The Europeans will realise that they can only survive if they integrate further, if they split up, their decline will be relentless. The influential Yu Yongding, former member of the monetary committee of the PBoC, summarises well the general impression of the Chinese financial elites on the future of the single currency. In his view there are two possible options: the EZ integrates further and creates common economic governance or it goes backwards and the union disintegrates. He predicts the former as the most likely scenario. "History shows us that monetary unions are very fragile in times of crises. This is true. But history is only good to explain history, not to explain the future. I think the euro is here to stay" (Yu 2009). This optimistic take on the euro coincides with the research results on Chinese perceptions on the EU by Zhu Liqun, a Chinese IR scholar. She also finds that the "Chinese are optimists and like to believe that the road is tortuous, but the

[2] For a European reaction to Feldstein's proposal, see Baldwin and Wyplosz (2010): "How to destroy the Eurozone: Feldstein's euro-holiday idea".

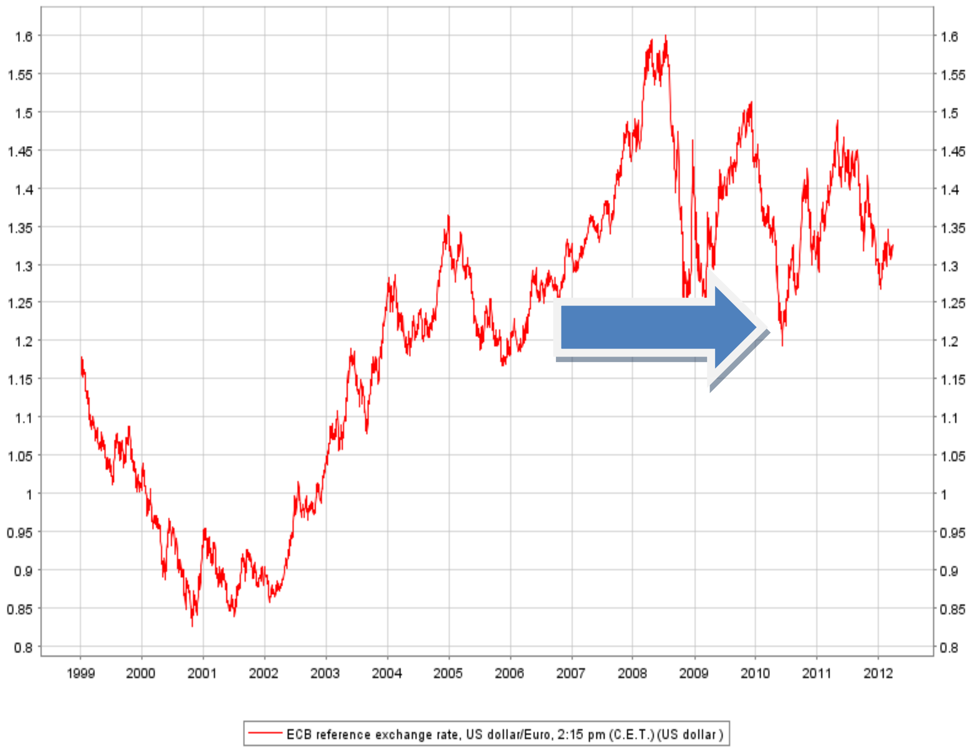
[3] Anonymous interviews with Chinese officials and think tank researchers in Beijing in March-June 2009 and May 2012. For interview notes, concrete location and date of the interview and rank of the interviewee, please contact the author through the editor.

future is bright'" when it comes to describing European integration, which they see as "irreversible" (Zhu 2008:150-1).

China's public relations support to the euro

Chinese policymakers' optimism on the future of the euro has been reflected in their actions. That the euro was able to maintain its exchange rate value above the US dollar even in the midst of its greatest existential crisis is partly due to Chinese confidence in the long term consolidation of the single currency. One of the most critical moments in the short history of the euro came on the 26 May 2010 in the midst of the Greek debt crisis when a report by the *Financial Times* disclosed that China's SAFE was "reviewing its holdings of eurozone debt in the wake of the crisis" (Oakley & Anderlini 2010). At that moment, the €750bn strong European Financial Stability Facility (EFSF) had finally been agreed but there was a lot of uncertainty in the markets and the euro was continuing in free fall approaching the $1.20 mark from over $1.50 at the end of 2009 (see Figure 2).

Figure 2: Euro-Dollar Exchange rate (1999-2012 March)



Source: ECB

Once the *FT* report was published, the reaction of the markets was imminent and the single currency plunged another 1.5%, nearing a four-year low against the greenback. Confidence in the euro was vanishing. However, in what can only be interpreted as a coordinated public relations rescue action, the Chinese government stepped in and stabilised the value of the euro in a decisive moment. Only hours after the *FT* report was published, in an unusual statement for its uniqueness in responding to media rumours (Li et al. 2010), SAFE labelled the report as "groundless" and stressed that as a "responsible long-term investor and, under the principle of maintaining diversified investments, Europe has been and will continue to be one of the major markets for investing China's exchange reserves" (Anderlini & Oakley 2010). To eliminate any shadow of doubt, the same day, Gao Xiqing, the president of China Investment Corporation (CIC), the Chinese sovereign wealth fund, also came out publicly in defence of the single currency by saying that "CIC will keep its investment level in Europe, no more, no less. Short term fluctuations won't bring serious effect on us" (cited in Anderlini & Oakley 2010). Chinese official euro-support did not stop there. Just a few days later, the president of another big Chinese investment fund, the National Social Security Fund, Dai Xianglong, also backed the single currency against speculative attacks by saying that the EZ's sovereign debt crisis was only temporary and that the more long term worry was "future turbulence in the dollar as a result of widening deficits in the US" (cited in Dennis 2010). The Chinese strategy to help the euro worked. The single currency reached a bottom of $1.1942 on the 8 June 2010 and it bounced back to over $1.30 less than a month later (see Figure 2).

China saves the euro in its moment of need

The influence of China in holding up the European currency was acknowledged by none other than the renowned investor George Soros who declared shortly after these events that "China saved the euro". In his words, "once it was discovered that China was a buyer, the euro jumped from its value of $1.20 to $1.30" (White 2010). After this move, Soros' perceptions on the future of the euro changed. Before, the possibility of a break up of the euro was in his mind (Allen 2010), but after "China had a role to play in its survival", his opinion changed to a more optimist outlook on the integrity of the EZ (White 2010). This is a significant change in perceptions since Soros was reported to have been in the dinner of hedge fund managers who decided in

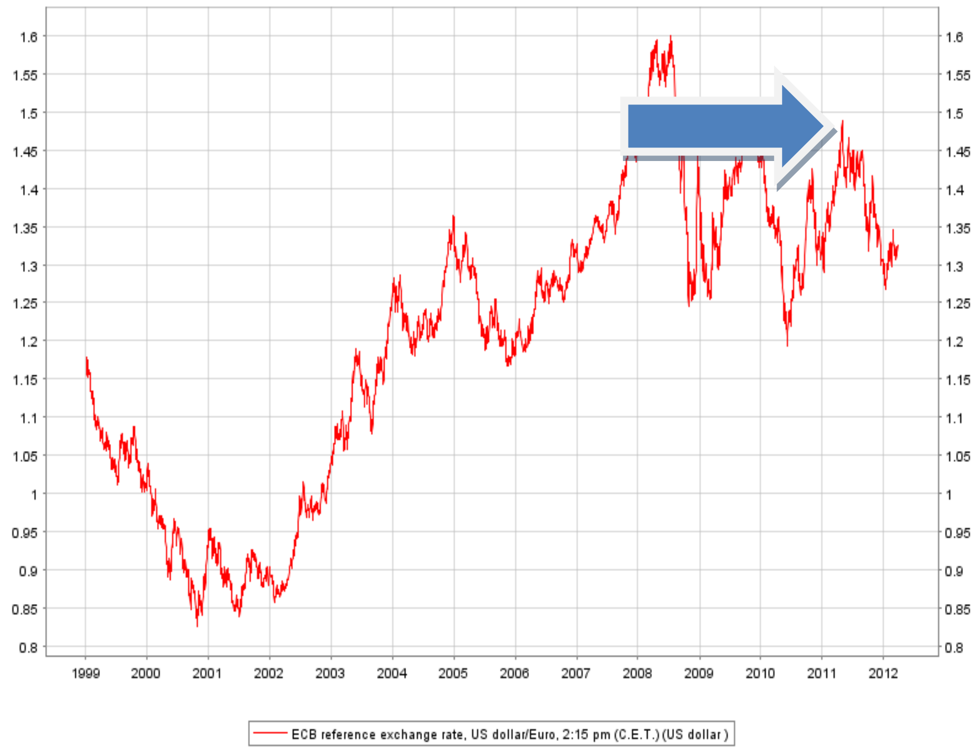
February 2010 to bet against the euro (Pulliam et al. 2010). It seems that Soros, and presumably many other investors bearish on the single currency, changed their views on the euro after being "burned" by China's euro-support strategy. His comments certainly hint in this direction.

The rest of 2010 China showed openly its support to the single currency by declaring openly that it was buying and will continue to buy bonds from the countries in the EZ periphery. In July 2010 it was leaked that it made a $1bn offer to buy Spanish debt (Oakley & Sakoui 2010), in August 2010 Yu Yongding, speaking informally on behalf of the PBoC, declared that his nation had bought "quite a lot" of European bonds (Zachariahs & Harui 2010), and in October 2010 China was reported to have invested first in Greek (*Handelsblatt* 2010) and then in Portuguese debt (Wise 2010). In November 2010, at the time when Ireland had to be bailed out (another critical moment in the euro crisis) the Chinese state-owned news agency *Xinhua* published an editorial entitled: "Euro will not fail", counteracting Anglo-Saxon scaremongering in the markets on the bleak future for the European currency. Yet again the Chinese authorities were keen to change market perceptions on the euro by stating:

> Contrary to the widespread claim that the eurozone is doomed to break up, the single currency will not fail, although it is facing the toughest challenge since its birth in 1999…As a major achievement of European integration, the euro is a landmark in the world's monetary history. It has become the second largest reserve currency as well as the second most traded currency in the world after the U.S. dollar. Despite its shortcomings, which have been exposed by the debt crisis, the euro has brought economic benefits and currency stability to its members. A breakup of the eurozone would be politically unacceptable (*Xinhua* 2010).

Again we see here certain correlation between the euro-dollar exchange rate and Chinese unequivocal public support for the European currency. Between 4 November and 29 November 2010, the day the *Xinhua* editorial was published, the euro plunged from $1.424 to $1.314, a considerable fall. Coincidently after 30 November 2010 the European currency entered a new multi-month rally reaching again a new high of $1.48 in April 2011 (see Figure 3). This is not to say that the euro's exchange rate moves depend exclusively on Chinese action. But the strong public support by a player of the calibre of China has certainly had certain influence in the markets.

Figure 3: Euro-Dollar Exchange rate (1999-2012 March)



Source: ECB

Chinese support to the euro continued in 2011. In January of that year the visit of the likely-to-be next Premier of China Li Keqiang to Spain was surrounded by rumours that China would invest €6bn in Spanish debt (Mallet & Wiesmann 2011). In April, when the then Spanish Primer Minister José Luis Rodriguez Zapatero visited China, Premier Wen Jiabao restated China's willingness to buy further Spanish debt, making Spanish analysts believe that China holds now approximately 12% of overall Spanish government debt (Junquera 2011). Anonymous interviews with Spanish officials in Beijing in May 2012 have disclosed that China has been quite active in the Spanish debt auctions in the past years. The success of China's strategy of making the investment community believe that it stands behind the euro was confirmed in February 2011 when the *Financial Times* chief correspondent on international finance Henny Sender (2011) wrote a piece suggesting that the reason behind the exchange rate strength of the euro vis-à-vis the greenback was that "the Chinese have been buying European sovereign debt in a big and – for China – very public way".

China supports the euro by word and deed

Up to that point, it was difficult to say whether China's support to the euro was mainly a public relations campaign or a genuine investment strategy. However, a few months later, in June 2011 Standard Chartered Bank confirmed earlier estimations that China was actively diversifying out of the dollar and buying more euro-denominated debt (Anderlini & Dalloway 2011). Since then and up to mid 2012 the two trends described above continued. Chinese officials showed publicly their support to the European currency and a number of studies pointed to the fact that China has indeed increased its purchases of euro-denominated debt. In October 2011, again in a phase when the euro was under considerable market pressure with risks spreads rising between Italian and Spanish ten year debt bonds and German Bunds, Chinese officials renewed their public confidence in Europe. Ahead of the annual EU-China meeting (which the EU authorities finally postponed until February 2012 due to the gravity of the crisis in Europe), Jiang Yu, a spokeswoman of the Ministry of Foreign Affairs of China, declared that "we have said many times that we support the measures Europe has taken to deal with the financial crisis… We believe these difficulties are temporary, and that European countries can reach unanimity and have sufficient ability and financial strength to resolve their own issues" (cited in Blanchard 2011). A few weeks later, the Minister of Foreign Affairs of China Yang Jiechi repeated the same message: "We believe that Europe has the complete wisdom and ability to solve the debt problem…China has always supported Europe's response to the international financial crisis and its economic recovery efforts" (cited in Wee 2011).

In March 2012, Tom Orlik and Bob Davies (2012) from the *Wall Street Journal* calculated that China had effectively diversified substantially its newly acquired foreign reserves between June 2010 and June 2011. While previously 65% of new purchases would be dollar denominated instruments in line with the overall distribution of the accumulated stock, during their period of study, dollar denominated assets would only count for 54% of total purchases. The authors explain this drop by pointing to China's increased interests in euro-denominated assets. They highlight that at the postponed EU-China summit in February 2012 Premier Wen Jiabao declared that "Europe is a main investment destination for China to diversify its foreign-exchange rates". They also pointed out that from October 2011 onward Klaus Regling, the CEO of the European Financial Stability Facility (EFSF), has been in close talks with officials from SAFE to increase China's participation in the fund. While it is unknown how much China has actually invested in the EFSF, "documents show that Asia, apart from Japan – essentially China – accounted for between 14% and 24% of purchases for three EFSF bond sales worth €13 billion in the first half of 2011", and as the authors remind us, "that was before Mr. Regling's Beijing trip", which means that China might have increased its share since then.

Finally, in March 2012 the vice-governor of the PBoC and head of SAFE, Yi Gang confirmed that China has propped up the European currency in the past two years by buying more euro-denominated debt (cited in Wang & Liu 2012). He summarised China's position with the following words: "We believe that Europe will ultimately overcome the debt crisis through their own efforts as well as with the help from the international community. China will continue to be a 'long-term and responsible' investor in Europe". For Yi, concerns over safety, liquidity and potential revenues are three major factors affecting the Chinese government's thinking when it tries to diversify its $3.2 trillion foreign reserve portfolio, and "under such principles, we will continue our investment in Europe". In this same intervention Yi confirmed that China has invested in peripheral European debt and that it has been a profitable investment, not least because inflation has remained low in the Eurozone. In principle, these words indicate that China was ready to buy more European debt from the periphery, but as will be shown in the third part this trend might have decelerated because it undermines Germany's strategy to solve the crisis.

3. Explaining China's support to the Euro

However, before we arrive to China's change of attitude in regards to supporting the euro after close collaboration with Germany, it is worth pointing out in this section why China is so confident in the long term success of the European currency and why is it willing to invest considerable political and financial capital in the project.

China's confidence in European integration

Ultimately Chinese confidence in the euro is derived from what China scholar Shambaugh (2008:128) calls 'cognitive dissonance', which is "the natural proclivity to selectively look for confirmation of one's pre-existing beliefs and to reject evidence that contradicts these beliefs". Chinese financial elites dismiss the idea of a euro break-up because they believe in the construction of a multi-polar world order out of US hegemony. In this ideal scenario they want to see a strong, united and independent EU pole with enough strength to act as a counterbalance to the US. The euro is the vivid representation of the European integration project, and therefore the possibility of its demise is rejected. The debt crisis in Europe has shown Chinese policymakers that perhaps they were too euro-optimistic and naïve. It has also shown them that European politics is extremely complex and difficult to understand due to the number of variety of stakeholders involved.

Ultimately, they have discovered that the EZ is less integrated than they thought, but this does not change the fact that overall China is quite positive on the future of Europe, not least because Europe and China have many similarities. Both are ancient civilizations that extend over an entire continent. They can both claim that they are or want to be "united in diversity". China, like the EU is conformed by different ethnicities, with different cultures and languages. In some ways both are semi-federal structures which face similar challenges and tensions because of their internal socio-economic differences and disparities (Song 2010). Arguably, if the EU would split up, regionalist forces would gain further momentum in China. This is a scenario that Chinese authorities would like to avoid by supporting the European integration project.

Diversification of foreign reserves

Another reason which explains why China has been supporting the euro is the fact that China has become over-dependent on the dollar. The value of the greenback has been in structural decline for some time and this is a major worry in Beijing since over 60% of the $3.2 trillion of foreign reserves are allocated in dollar denominated assets. Diversification has become a major imperative and, for now, the euro is the only alternative to the US dollar. A foreign exchange (FX) market player with the fire capacity of China has limited choices when it comes to diversifying its assets. It needs a deep, broad and liquid market to allocate its FX investments. China cannot diversify large amounts of its foreign exchange reserves in Canadian, Australian or New Zeeland dollars because it would collapse these currencies in a matter of days if not hours. The same can be said of gold which has reached record levels in recent times. Even international reserve currencies such as the Swiss franc, the Japanese Yen and the British pound would have limited absorption capacity. The only other currency that can cope with Chinese diversification is the euro, and even so it has its limits. When the European currency reached $1.60 to the dollar in mid 2008 (see Figure 2 or Figure 3) the competitiveness of EZ exporters, especially of those based in the EZ periphery who are more sensitive to FX variations, suffered severely. It can certainly be argued that the desire to diversify out of the dollar by emerging markets, including China, and the consequent demand for euro-denominated assets, was one of the causes of the EZ debt crises. The euro's inherent 'appreciation-bias'(Vermeiren 2012) has eroded the competitiveness of the EZ periphery and consequently enlarged the current account deficits of countries such as Greece, Portugal, Spain and Italy.

The over-dependency of China and the international monetary system at large on the dollar was clearly visible during the credit crunch crisis of 2008. In the two quarters that followed the collapse of the investment bank Lehman Brothers in September 2008 dollar liquidity dried up due to the deleveraging operations of major US financial institutions and the risk aversion behaviour of international investors. The necessary blood in the operations of world trade was missing and this meant a collapse in import orders of Chinese products and the consequent dismissal of 20 million Chinese workers. As the governor of the PBoC Zhou Xiaochuan (2009) has pointed out, the global financial crisis has shown again that the international monetary system dominated by the dollar has an inherent flaw called the Triffin dilemma. By being the issuer of the world's currency, the US needs to run current account deficits. This in turn means that global imbalances are continuously generated in the system. First these imbalances were with Western Europe (1960s and 1970s), then with Japan (1980s) and now with China. To avoid this, the international community should promote the use of the IMFs Special Drawing Rights (SDRs), which is a basket composed of the dollar, the euro, the yen and pound sterling. However, Beijing knows that this is a long-term and difficult process, not least because the US is unwilling to support the idea. Therefore, the only other option is to promote other international currencies and until the Chinese RMB reaches its full potential, the euro is the only alternative in town.

Preserving the value of euro-denominated debt

Apart from diversifying more of its dollar denominated assets into euros, China also needs to worry about the value of the euros that it already has. As mentioned, in 2010 sources within SAFE disclosed that approximately 26% of China's foreign exchange reserves were allocated in euro-denominated instruments. If we believe that China has continued to gradually diversify out of the dollar since then, this percentage might be larger today. Chinese officials interviewed in May 2012 under condition of anonymity say that the share of the euro is now much closer to 30% of total reserves. Some European scholars put the euro share even at 33% (Casarini 2012). Given that China has $3.2 trillion in reserves, this means that its euro holdings are around $1 trillion. To put this into context, the proposed permanent European Stability Mechanism (ESM), the de facto European Monetary Fund that will substitute the current EFSF, will only have €500 which is roughly $625 at the current (August 2012) euro-dollar exchange rate of $1.25. In other words, and to borrow a phrase widely used in recent times, the euro has become 'too big to fail' for China. By being the second most used international currency, the European currency is in a similar position as the greenback. It has become systemically important. Thus, the same arguments that are used in the US to explain why China will not pull the plug on the dollar (Krugman 2009) can be applied to the euro. China needs to keep the value of the euro up to avoid major losses in its existing euro-denominated holdings.

The importance of the European market

China's calculations are not only focused on maintaining the value of the euro to keep the purchasing power of its national wealth allocated in euro-denominated products. It also needs a strong euro to maintain its export competitiveness in the EZ and the EU at large. The EU is actually China's main export market so if the euro depreciates vis-à-vis the RMB, Chinese products will be in less demand. This is an important factor because China is still largely dependent on its exporting sector (although the share of exports in its growth to GDP ratio has declined since the crisis) to keep unemployment low. Furthermore, the EU market is important for Chinese exports but also for its imports. The EU is the main provider of high value added technology to China. Therefore China has an intrinsic interest in maintaining economic, political and social stability in the EZ.

Providing financial aid to a continent with a per capita income much higher than China's is not a popular option among the Chinese public. This is one of the reasons why the Chinese leadership has avoided declaring publicly how much it has invested in EZ peripheral debt. Nonetheless, many commentators in China have ridiculed the suggestion that a poor China should help a rich Europe (Xie 2011). But despite this criticism, the Chinese authorities have felt obliged to support the consumption and productive capacity of the European market. As Premier Wen Jiabao explained in February 2012, when German Chancellor Angela Merkel visited Beijing, help to Europe is not only in the interests of the Europeans but also beneficial for China. As he explains:

> "Now Europe is facing a debt crisis and we must consider relations with Europe strategically to protect our national interests. On the one hand, our biggest export market is Europe. On the other hand, Europe is our biggest source for importing technology. From this perspective, helping to stabilise European markets in fact amounts to helping ourselves. We must make all quarters of society understand this point" (cited in Buckley 2012).

It is important to note here that China does not want the euro to become too weak, but strategically it does not mind either to see the euro weaken so that it can buy European high tech products and invest in the EZ at a lesser cost. This is something to bear in mind for the third section. In this regard, the euro crisis provides a good opportunity for China to invest further in the European continent. Chinese businesses are eager to acquire European companies in order to improve their knowledge and capacity in high technology, professional management and international branding. While before the 2010 euro debt crisis China's foreign direct investment in Europe would not reach €3bn, this figure has been reported to have increased to $10bn in 2011 (Godement et al. 2011; Anderlini 2012).

Increasing the political influence in Europe

The reasons behind China's support to the euro are certainly not only of economic nature. Politics plays an important role too. By supporting the euro and the EZ in a moment of crisis, the Chinese government is seeking to augment its political influence in Europe and gain the Europeans as allies in economic and monetary governance disputes. This was proven in the 2010 meeting between Wen Jiabao and the euro-troika officials, shortly after it became evident that China had stepped in to stabilise the euro. Unlike on other occasions when the main theme was the appreciation of the RMB, as demanded for some time by the US, this time ECB president Trichet and his colleagues had to perform a balancing act between their demands and their explicit gratitude for China's "confidence in sovereign treasuries in Europe" (Grajewski & Taylor 2010). Since that meeting, Europe, unlike the US, has restrained from publicly criticising the under-appreciation of the Chinese RMB.

By September 2011, after more than a year of verbal and actual support to the European currency, China started to ask openly for some returns for its help. Granting China market economy status became one of the demands. Again the thinking of Chinese policymakers was channelled via the state agency *Xinhua* which in a commentary stated that

> "Since the eruption of the global financial crisis and the debt crisis in Europe, China has offered help to Europe…Since last year, China has purchased bonds of several European countries, trying to save nations deep in a debt crisis… By contrast, it is a pity that the EU side still shows no sincerity on the issue of recognising China's market economy status…The earlier that the EU announces its recognition, the earlier it could demonstrate its sincerity towards China, winning more popularity and friendship among Chinese people" (Wu 2011).

These demands by Chinese policymakers have been interpreted by some as a strategy of taking advantage of Europe in its moment of need. It is argued that China's euro debt buying campaign has been a well orchestrated public relations strategy aimed at increasing China's political influence in Europe with little cost. Godement et al. (2011) argue for example that, unlike in the US, in Europe there is no transparency regarding who holds European sovereign debt so China can claim that it has been buying European debt without any public disclosure of these purchases. On the other side, European member states might use this lack of transparency for their own benefits. They might claim that China has invested in their bonds to steer market perceptions in their favour when this is actually not true. While more transparency in European debt markets would certainly be welcomed, it is doubtful whether China's strategy was exclusively a PR campaign. As was presented above, there are a number of studies that argue in favour of China's diversification into the European currency. This would certainly explain why the euro has maintained its exchange rate value throughout the crisis. The fieldwork research undertaken for this study would support this thesis.

If China has indeed increased its purchases of European debt and at the same time 'saved the euro', as George Soros claims, it is understandable that China asks for some favours from Europe, and it is also perfectly probable seeing Europe conceding some ground in certain areas. In the last EU-China Summit (2012), for instance, the two parts have agreed to review China's market economy status. This appears to be a concession of the Europeans to the Chinese. The market economy status issue might not be the only one that the Chinese authorities might negotiate in exchange for financial help. It is very likely that Beijing might use this opportunity to ask Europe again to lift the arms embargo or to reduce its voting power in the IMF so that emerging markets, including China, have a greater say. Arguably, Sino-European collaboration has already been at work behind the competition for the new IMF managing director after Dominique Strauss Kahn's resignation. China was one of the biggest supporters of Lagarde to head the IMF despite widespread demands for a non-European candidate. It is quite likely that the Chinese and French governments reached an agreement by which Beijing would support Lagarde and in exchange Lagarde would make Min Zhu, a Chinese official and economist, her deputy.

The desire for a G-3 world

While certain influential US commentators in International Relations such as Zbigniew Brzezinski have proposed a G-2 formed by the US and China as the main decision-making body in international affairs, this is a proposal that does not find great support among Chinese policymakers. As mentioned above, China prefers to construct a multipolar world and Europe is seen as an important pole in the new configuration. As Khanna and Leonard (2011) indicate, China prefers to have a G-3 configuration in the management of world affairs and this is another reason why it has supported the euro during the current crisis. Chinese officials recognise that great part of the multilateral order that has emerged in the past fifty years is due to European efforts. When it comes to promoting coordination and cooperation, the enforcement of the rule of law and the pooling of sovereignty at the supranational level Europe has certainly decades of expertise. Chinese policymakers show great respect for this legacy.

A triangular relationship in the management of world affairs would also be of China's liking because a triangular power balance is synonym of stability in traditional Chinese culture. This is reflected in how Chinese policymakers think about the future of the international monetary system for instance. The words of Qin Yaqing, senior advisor to the Ministry of Foreign Affairs of China, are a good summary of the general feeling in China. Asked about the future prospects of the European currency, he answers as follows:

> I think the euro will become a leading currency with the dollar and I also think that this is a positive development. Only one currency can bring stability but also instability. I am of the belief that a few currencies can bring more stability to the system. This is what I would call the benefits of 'benign competition'. In my belief in the future we will have three major currencies: the dollar, the euro and a currency in Asia (either the RMB or a common currency). In East Asia there is now a strong commitment to use local currencies in order to avoid further exposure against the dollar, this shows that a multi-polar currency system is in demand (Qin 2009).

By supporting the euro, Chinese officials are moving one step forward towards this triangular configuration. The other big step is to internationalise the RMB, and here too quite significant process has been achieved. As Barry Eichengreen (2011) argues, it is quite likely that in 10 to 15 years, the international monetary system will be a tripolar monetary system. Whether this configuration will be more stable than current dollar unipolarity is beyond the scope of this article.[4]

By stretching its helping hand to Europe, China is also starting to show that it wants to be a responsible and trustworthy partner in international affairs. China's strategy has been quite measured in many regards. Instead of presenting itself as Europe's 'white knight', it has insisted in the argument that China can certainly help, but ultimately it is down to the Europeans to solve their own crisis. China has discovered that it is in a similar position as Germany. It knows that it has the financial capacity to rescue the EZ periphery, but it is also aware that the long term solution for Europe lies in the improvement of the competitiveness of weaker countries through structural reforms and in the strengthening of the governance structures of the EZ in order to establish some sort of fiscal union. This more nuanced strategy was again leaked through an editorial in the state-controlled *Xinhua* agency published shortly after the EFSF head Klaus Regling, a German official, visited Beijing in October 2011. In this commentary, which is quite likely to reflect the views of the Chinese leadership, one can read that China's purchase of European debt is a positive signal, especially because

> "Beijing's good-will gesture is a good response to those who see China as a threatening rival to Europe. Despite differences in politics, economy and culture, China and the EU are still good friends and partners…However, amid such an unprecedented crisis in Europe, China can neither take up the role as a saviour to the Europeans, nor provide a 'cure' for the European malaise…Obviously, it is up to the European countries themselves to tackle their financial problems. But China can do within its capacity to help as a friend" (*Xinhua* 2011).

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[4] For a discussion on the scenarios for a tripolar monetary system see Bénassy-Quéré & Pisani-Ferry (2011).

In many ways Chinese policymakers are quite frustrated about the slowness of the Europeans in tackling the euro crisis. In their view Europe should be much faster in its political integration project in order to overcome the crisis as soon as possible. Ultimately, in their view, the euro can only survive if there is a political union behind it to underpin it. This eagerness for accelerating the process of reform is certainly striking. No-one else more than Chinese policymakers should understand that it takes considerable time to establish a political union out of different nation states with different cultures and traditions. The long history of China is a case in point.

4. Sino-German Collaboration in Solving the Eurocrisis

The crisis, however, has shown Beijing one thing: that Germany is becoming the key player in the future of Europe. The truth is that Chinese policymakers have always shown great respect and admiration for the German economic powerhouse, and thus in recent years they have tried to strengthen the strategic ties with Berlin (Kudnani & Parello-Plesner 2012). China is slowly overtaking the US as the main destination of German high tech products, and Germany is one of the largest export markets for Chinese goods (Quah 2012). Since the times of Gerhard Schröder, the German chancellor visits China once per year and this has not changed with Angela Merkel. However, despite this close relationship, it took policymakers in Beijing some time to understand the German strategy in regards to solving the euro crisis. Partly, this is because the politics of the EZ is extremely complex, but also because most of the public information available to them comes filtered through the Anglo-Saxon press, which, as mentioned before, has for the most part a euro-sceptic approach.

Instead of reading *Der Spiegel*, *Le Monde* or *El País* to know what is happening in the eurozone, Chinese policymakers and pundits rely on the coverage of the English written press like the *Financial Times*, *The Wall Street Journal* or the *New York Times*. Thus, open calls in these newspapers by respected economists such as Nouriel Roubini and Paul Krugman for a Greek exit put Chinese policymakers extremely nervous back in 2010 and encouraged them to buy first Greek debt and then debt bonds from the countries most likely to suffer contagion such as Portugal, Spain or Italy. For their surprise, though, Berlin, instead of thanking Beijing for its financial help, send a clear message that these purchases were counterproductive. As several

Chinese and European officials confirmed during interviews in Beijing in May 2012, the response from Berlin to Chinese purchases of EZ peripheral debt has been consistent since 2010: Sovereign bond spreads are an efficient pressure mechanism to force political leaders in the peripheral countries to undertake the necessary structural reforms to regain competitiveness. It is precisely in this way how Germany, in collaboration with the ECB, was able to force the resignation of Silvio Berlusconi (Kirkegaard 2011).

Overall the German strategy, as described by Chinese officials, has been to use this crisis to "build more Europe" along federal lines. This is achieved by forcing reluctant countries to agree to pool further sovereignty under supranational structures. It needs to be emphasised here that Germany has always been the most Europeanist country in Europe, and the country that has always claimed that monetary union is impossible without political union (Marsh 2009). Thus, Merkel's 'hands-off' approach has the clear objective to use the pressure of the markets to achieve the fiscal and political union necessary to make the euro a sustainable currency (Kirkegaard 2011). The pressure of the markets is used in two steps. First, the market strain forces political leaders to undertake the reforms demanded by Brussels, Berlin and Frankfurt so as to avoid an embarrassing default. Second, if these efforts are not enough and the pressure continues, these countries are then obliged, as demanded now in a more open way by the ECB, President Mario Draghi, to ask for a rescue package by the EFSF or the ESM, which means that they will have to give up further sovereignty to Brussels.

So far the German strategy seems to have worked. The 17 countries forming the EZ have agreed to sign a fiscal compact which restricts further fiscal autonomy, Greece, Ireland, Portugal, Spain and Cyprus have already asked for rescue funds and thus given up certain degree of sovereignty, and as of the time of writing EZ policymakers are debating the option of making the ECB the main supervisor of the banking system for the entire EZ. These are important steps toward the fiscal union that Germany has demanded as a quid pro quo to the creation of a common debt liability such as Eurobonds (Weidmann 2012), which is precisely the debt instrument that policymakers in China have always demanded from the EZ to continue safely their diversification drive out of the dollar (Otero-Iglesias & Steinberg 2012).

Nonetheless, as several Chinese policymakers have made clear, the German strategy is not without risks. They think that this Russian roulette game can seriously backfire. Germany seems to be ready to push its partners toward the edge of the cliff in order for them to agree to create a fiscal union, but markets and overburdened populations can overreact and financial panic can push some of the big players such as Italy over the cliff. This is the reason why China has been buying sovereign debt bonds from the periphery. As a senior Chinese official disclosed, China has been intervening in the markets because it believes that the German strategy is too dangerous. For China, social and political stability is paramount and after seeing the images of street riots in Athens and the protests in Madrid China had no other option than intervene.

Nonetheless, it appears that after meeting in numerous occasions with German and European officials over the years, Chinese policymakers have decided to lower their profile and instead of ‘active support’ switch to a strategy of ‘wait and hope’ that the German strategy will work. Some Chinese officials recognise that perhaps it was a mistake to intervene so openly in the EZ periphery markets and thus undermine Germany’s long term strategy. They believe that it is smarter for China too stay on the sidelines for the moment. They compare it to intermingling in the affairs of another family. This is unwise. Again, this change of strategy by China seems to have had certain influence in the euro-dollar exchange rate value. While throughout 2011 and until mid 2012 the euro was comfortably above \$1.30 with FX market participants acknowledging that this was a floor set by the PBoC (Casey 2012), this has changed since May 2012 (see Figure 4), with the euro approaching again the \$1.20 mark, which is precisely the level that triggered China’s euro-support strategy in 2010 in the first place. See the first section.

Figure 4: Euro-Dollar Exchange rate (1999-2012 August)

Source: ECB

Coincidently, this sudden deprecation of the euro coincides with Li Keqiang's first official visit to Brussels. Again this might not be the only reason why the euro has lost in value, but perhaps German and European officials were able to convince the most-likely next Prime Minister of China that it would be helpful for the EZ if China would stop propping up the euro. Not least because a weaker euro would be one of the best ways to help the EZ periphery regain competitiveness (Feldstein 2012). Li Keqiang's remarks during his visit can certainly accommodate this approach. While he confirmed that China had "purchased bonds issued by European countries several times", he did also say that China was ready "to explore possible and effective means to co-operate with the relevant parties and to make a joint contribution to addressing the issue of Europe's sovereign debt". Perhaps the new contribution is to let Germany and the European authorities solve the crisis following their own strategy. As mentioned, a weaker euro would not be too bad for China either. Yes, Chinese products will be less competitive in the EZ, but equally investments in the EZ will become cheaper.

4. Conclusion

The aim of this paper has been to analyse China's strategy in relation to the future of the euro. This has been done in three steps. The first section presents an exhaustive summary of China's public relations and financial support to the euro since its birth up to the current euro sovereign debt crisis. The second explains why China has been so supportive of the euro. Finally, the third focuses on how China might have changed its strategy from 'active support' to 'wait and hope' that Germany's strategy toward the creation of a fiscal union will work.

Differently to widespread perceptions in the Anglo-American world that the euro is doomed, policymakers and financial elites in China believe in the long-term sustainability of the European single currency and this sentiment is reflected in their actions. As the international investor George Soros has indicated, it can be argued that China saved the euro in its direst moment. This paper presents evidence to support this thesis. Both by articulating a public relations campaign of support through public statements and *Xinhua* commentaries to counterbalance euro-scaremongering coming of the Anglo-American press and by claiming to buy and actually buying debt from cash-strapped EZ peripheral countries, the Chinese leadership has had great influence in supporting the market value and credibility of the European currency. While the buying of European debt by China has been widely reported in the press, little attention has been given to how China has also helped to stabilise the market value of the euro by steering market sentiment in favour of the single currency through the effective use of communication and information channels. Paradigmatic of this is SAFE's 2010 public communiqué denying a *FT* report claiming that China was considering reducing the share of its reserves in euros. This is one of the first times ever that SAFE has reacted to news appearing in the press.

What explains this euro support by China? Several reasons have been highlighted. China wants a strong and united Europe for international and domestic considerations. Internationally, China favours a multipolar world order, and in this imaginary scenario Europe should be an important pole. In first instance, to counterbalance US power, and secondly, because it is the region with more experience in supranational coordination and cooperation. Domestically, China wants a strong Europe because a fragmentation of Europe could potentially reinforce regionalist tendencies within China bringing social instability. On the economic side there are powerful reasons for China to support the euro. China needs to diversify out of the dollar and it needs to protect its already substantial stock of euro-denominated assets. With around $1 trillion at stake, the euro has become 'too big to fail' for China. The European market remains vital for China too. The EU is its biggest export destination and the biggest origin of technology. A prolonged crisis in Europe is neither in the interest of the Europeans nor the Chinese. Finally, China is using this opportunity to enhance its image as a responsible power in Europe. China tries to be a good friend. It is here to help but it is also honest in saying that ultimately only Europe can save Europe.

In this regard, Chinese policymakers have recognised that the main player for the survival of the euro is Germany. There is where power in Europe lies. Thus, in recent years they have strengthened their ties with Berlin and they have discovered that Germany has its own strategy to solve the crisis. It is using the pressure of the markets upon the EZ periphery to force these countries to give up more of their fiscal sovereignty to Brussels. Some high profile German policymakers have already declared that the ESM can potentially become a centralised fiscal authority for the EZ (Asmussen 2012). The evidence collected for this study suggests that Germany has discouraged China to buy further debt from the EZ periphery to keep the pressure of the markets on. Chinese policymakers have reluctantly accepted this strategy. For one, because they think that the German strategy might backfire and bring social and political instability or market panic in the EZ countries, and two, because with the current spreads China would be able to win a handsome return from its investments in EZ peripheral debt bonds if the situation improves. Nonetheless, since mid-2012 it seems that China has backed off from supporting actively the euro. This has coincided with a depreciation of the single currency. On the one hand, this means that the Chinese national savings in euros are losing part of its value and that Chinese products are less competitive in the EZ, but one the other hand, it also means that purchase of German high-tech and foreign direct investments in Europe are less costly. As the Chinese leadership tries to rebalance the Chinese economy from cheap manufacturing to high value-added goods and domestic consumption a cheaper euro might not be that bad news either for the EZ periphery as for China.

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