



## Nervous Giant

China and the Financial Crisis

Patrick Farrell

Staff Writer

### Abstract

While the current financial crisis is widely acknowledged to be global, surprisingly little attention has been paid to its effect on one of the largest players in the global economy. China has weathered the crisis extremely well, though its growth has slowed slightly. I will analyze this by looking at China's purchases of debt, the Chinese holdings of debt in the United States and its growing holdings in Europe, and the policy decisions directing this. This shows an intriguing change in the policy decisions that led to China becoming such a large holder of American debt. China amassed its large holdings of debt from the United States by merit of the strong trade relationship between the two countries, as well as the stability of the U.S. dollar. However, China's interest in buying up Italian debt and forming stronger bonds with other Eurozone and European countries seems to speak to a different motive. Rather than allowing its reserves of foreign capital to grow over time, as it did with its U.S. debt, China is making a more aggressive move in this case. Thanks to its relative stability during the crisis, I believe this shows us that China is seeking to both ensure the continued security of its economic growth and increase its economic influence, thus using the instability of the global financial crisis to kill two birds with one stone.

**Keywords:** *China, Eurozone, debt crisis, financial crisis*



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### China and the Financial Crisis

Patrick Farrell

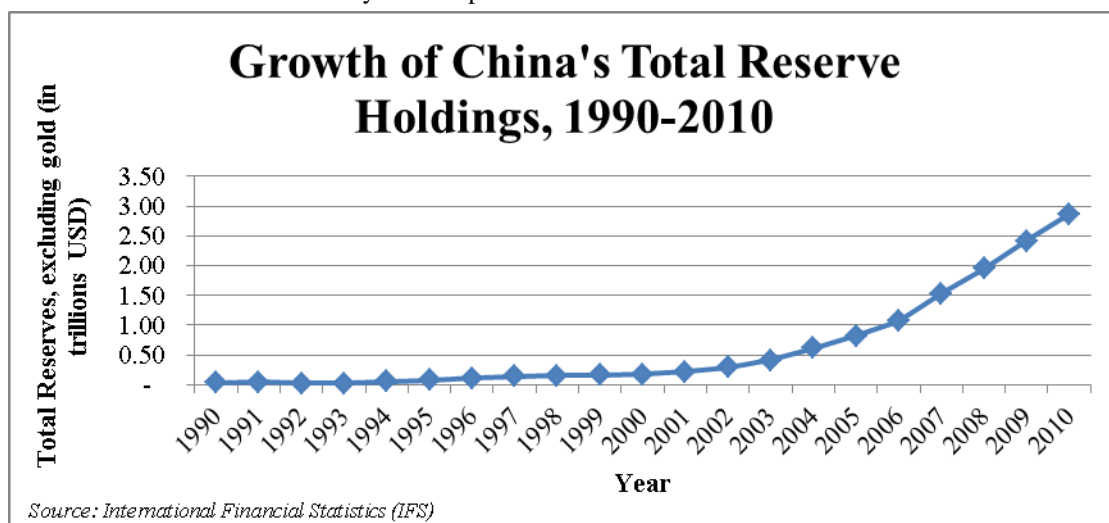
Staff Writer

The financial crisis of 2008 and subsequent global economic downturn has affected numerous countries across the globe, yet surprisingly little attention has been paid to one of the largest players in the world economy. China has weathered the crisis better than most other nations, only suffering from a slight decrease in gross domestic product (GDP) growth. In stark contrast, the crisis has thrown many European economies into turmoil. Some European countries have called upon China to aid in their economic recovery, and China has displayed interest in purchasing European sovereign debt. I will analyze what might cause China to intervene in Europe and why this sets a different precedent for Chinese foreign policy by discussing China's potential purchases of debt, comparing Chinese holdings of United States government debt to China's growing European holdings, and evaluating the policy decisions directing these outcomes. China is actively seeking to purchase European debt and invest in the recovery of Europe in

order to ensure the continued security of China's economic growth and global economic influence, effectively using the instability of the global financial crisis to kill two birds with one stone.

China's leverage in the global economy emerges from the nation's status as both a major exporter and buyer of foreign debt. Because China runs a trade surplus with other countries, it accumulates large amounts of foreign currencies from transactions and invests these reserves in foreign bonds and government debt. This trade surplus enables China to use a large percentage of its newly accrued foreign reserves each year to purchase American treasury bonds and other dollar assets in order to maintain exchange rate stability against the dollar. With the American trade deficit to China reaching \$252 billion in 2010—lower than the \$282 billion deficit in 2008—China was able to add to its foreign reserves.<sup>1</sup> China has total reserves of \$3.2 trillion, the most of any country in the world. Of those reserves, around 70 percent are held in US dollar-denominated assets<sup>2</sup> and only a quarter of China's reserves are Euro-denominated assets,<sup>3</sup> even though the United States and Eurozone have similarly sized economies (GDP in 2010 of \$14.6 trillion and \$12.2 trillion, respectively).<sup>4</sup>

Even with rapidly decreasing investor confidence in Eurozone countries' debt, China is now showing interest in intervening in European sovereign debt markets. Zhang Xiaoqiang, the vice chairman of

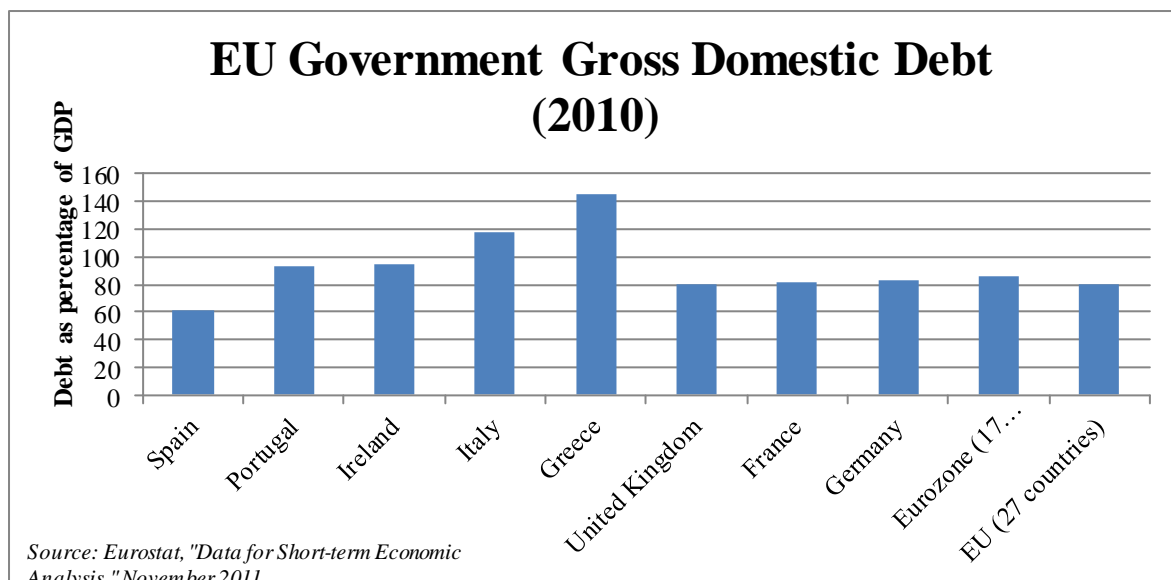


China's top economic planning agency, the National Development and Reform Commission, says that China is willing to buy foreign capital within its capacity.<sup>5</sup> China possesses 30 percent of the world's total reserve holdings, demonstrating the vastness of its ability to purchase and stockpile foreign reserves. Still, the reason for China's interest in European debt is unclear because of the risks involved.

The European sovereign debt crisis erupted in 2010 and has been characterized by the rapid growth of debt in several European countries.<sup>6</sup> Eurozone debt as a percentage of GDP declined overall during the period of 1990 to 2007, but the debt has jumped from 66.3 percent of GDP to 85.3 percent across the Eurozone, since 2007.<sup>7</sup> Some countries experienced even harsher changes, such as Greece, whose debt as a percentage of GDP ballooned to 142.8 percent, necessitating massive bail-outs from Eurozone nations and the IMF. In conjunction with Ireland, whose slight 2006 budget surplus reversed into a deficit in 2010 and 2011, Italy's debt as a percentage of GDP has also grown immensely, and currently ranks behind only Greece in the Eurozone. As a result, debt ratings in many European countries have been downgraded by Moody's and Standard & Poor's.<sup>8</sup> The ever-increasing deficits and government debts have created a spiral effect, decreasing investor confidence in Eurozone governments' ability to pay back their debts, thus

increasing the cost of borrowing, and making investment in these countries even more risky.

Yet China continues to pursue investment in those countries entangled in the European debt crisis. Overtures have been made to Ireland, whose President Mary McAleese met with Chinese officials in September 2011 to deepen cooperation between the two countries.<sup>9</sup> Ireland has also welcomed Chinese direct investment as a way to aid economic recovery.<sup>10</sup> Greece, with its massive government debt, has also been the recipient of Chinese investment. In October 2011, China and Greece agreed to a 35-year deal that allows China to operate Greece's main port.<sup>11</sup> China has also agreed upon terms to upgrade Greece's marine fleet.<sup>12</sup> These investments have provided China with the economic foothold in Greece to continue with future investments in infrastructure, tourism, and construction. There has also been speculation that China will increase its involvement with Italy as well.<sup>13</sup> Italy has appealed to China for an economic lifeline, hosting representatives from the China Investment Corporation, a state-owned global investment fund, in September 2011. Reports that China might purchase Italian bonds were also enough to lift the value of European shares and briefly increase investor confidence in European debt.<sup>14</sup> In particular, China's presence in these countries' economies and debt markets provides credibility to Ireland, Greece, and Spain among



international investors and businesses.

These purchases and investments point to a change in Chinese economic policy, and suggest the importance of international trade to China's economic development. According to Susan Shirk, author of *China: Fragile Superpower*, foreign trade comprised 75 percent of China's GDP in 2007. Thus, the Chinese economy is left vulnerable to shifts in the international economy, despite the country's tendency toward cautiousness when formulating foreign policy decisions. "If a backlash against China were to shut it out of key markets," says Shirk, "economic growth would slow and domestic unemployment could rise to dangerous levels."<sup>15</sup> Therefore, Chinese politicians have traditionally tried to avoid backlash, a risk that may endanger the Chinese economy. Nonetheless, China's current interest in purchasing risky European debt is a much less cautious strategy, given the nation's customary approach to the international economy.

These policies suggest that China is reacting to external economic pressures in a novel way. China is using its immense reserves to increase its economic influence in Europe and ensure continued Chinese economic growth domestically. The current Eurozone debt crisis has given China an opportunity to ensure economic stability for itself and increase its presence in Europe. Before the financial crisis, China's trade with the European Union had been increasing, and China is now the European Union's second biggest trading partner.<sup>16</sup> With the majority of China's economy based on foreign rather than domestic consumption, a continued slump in the market of one of the largest consumers of Chinese goods could stall growth in China and lead to unemployment.<sup>17</sup> Wen Jiabao, the current Chinese Premier, stated in a conversation with European Commission President Jose Manuel Barroso that the EU's economic stability is important to the stability of the world economy.<sup>18</sup> Jiabao went on to state that China could best aid in the global recovery by ensuring its own growth.<sup>19</sup> Because China's stability depends on the global economy, China has a direct stake in the outcomes of the European debt crisis.

China also has other motives in purchasing

European sovereign debt. China has a special interest in having its World Trade Organization (WTO) status redefined by the European Union as soon as possible.<sup>20</sup> China currently is not recognized as a full market economy by the European Union, which allows the EU to place restrictions on Chinese products. For example, the prices of Chinese products are often inflated on the grounds that China is attempting to practice "dumping," or selling products at artificially low prices. China is scheduled to be recognized as a market economy by all WTO members in 2014 and over eighty countries already recognize China as a market economy; however, Japan and the U.S. currently do not, allowing these two major importers to place restrictions on Chinese exports as well.<sup>21</sup> Should the Chinese purchase European debt and provide stability, China could have additional leverage to ensure EU recognition of its status as a full market economy. This would cause a shift in China's bargaining position, which might prevent other economic powers from using China's nonmarket status to create more favorable trade agreements.<sup>22</sup>

Both of these two explanations suggest that China is becoming more assertive in an attempt to ensure its interests abroad. The current economic crisis has thus far been unable to stall the growth of the Chinese economy; however, the Chinese economy could be rendered extremely vulnerable if the crisis continues. Because of China's exposure to foreign economic trouble, the crisis's magnitude has forced China to change its strategy of making cautious economic decisions when dealing with other countries. Because the current European debt crisis is threatening China's ability to export to foreign markets, China has been increasingly willing to intervene in many of the countries the crisis has affected the most. By buying European debt and investing in European countries, China has ensured a foundation for future access into the large European market and has also attempted to avert immediate domestic instability by helping the global economy avoid future meltdowns.

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*Notes*

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<sup>3</sup>“China Must Not Buy Euro Debt: Ex Central Bank Advisor,” *Reuters*, September 21, 2011, Internet (accessed October 19, 2011).

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<sup>15</sup>Susan L. Shirk, *China Fragile Superpower* (Oxford: Oxford University Press, 2007), 24.

<sup>17</sup>Eurostat, “China,” Luxembourg: 2011, Internet (accessed December 6, 2011).

<sup>18</sup>Zhang Chunyan and Zhang Haizhou, “Chinese Consumer Stimulus ‘good for Europe,’” *China Daily*, September 7, 2011, Internet (accessed October 19, 2011).

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<sup>20</sup>Bloomberg News, “Wen Says World Must Get ‘Houses in Order,’ Not Rely on China,” *Bloomberg News*, September 14, 2011, Internet (accessed October 19, 2011).

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<sup>23</sup>“No Need to Nitpick over China’s Market Economy Status,” *People’s Daily*, September 28, 2011, Internet (accessed October 19, 2011).