

## How China plays Europe

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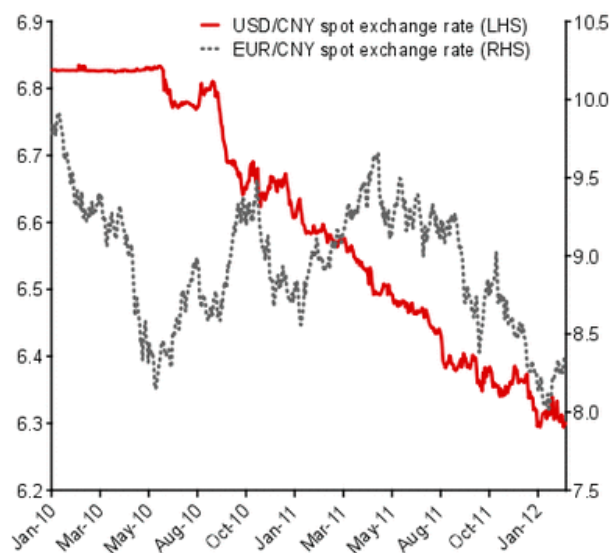
Almost four months have passed since Nicolas Sarkozy rushed out of a euro-rescue summit and announced that he was putting in a call to Hu Jintao to muster Chinese help for the euro area. Now we have Wen Jiabao telling a joint press conference with visiting Angela Merkel that China is considering 'involving itself more deeply' in efforts to address Europe's debt crisis.

What does this mean? Like other Asian countries with deep reserves, Beijing has undoubtedly gone on diversifying into euros in recent months and is all too aware of the impact a serious downturn in Europe would have on its exports as discussed in our report on the outlook for 2012. But it does not appear to be ready to offer the kind of aid the French leader was soliciting. Since it does not want to become involved in the politics and economies of individual European countries, China would like anything substantial to be channelled through the IMF, presumably in return for increased voting rights there. But the IMF advances funds to countries, not to entities such as the euro bailout bodies being mooted as recipients of Mainland largess. And Wen's bottom line, like that of every other Chinese leader who has spoken on the matter, is that it is up to Europe to craft its own salvation by reducing the debt load and pushing through structural reforms, a recommendation that chimes with Angela Merkel's views which she stated once more during her visit to the PRC this month.

### Cherry picking

So where is China's real interest in Europe? It is concerned about the impact of a major European recession on its exports. There is an obvious currency effect feeding through from the dollar-euro rate (see chart below) which could affect the competitiveness of Chinese exports especially if, as we expect, the renminbi is pegged to the greenback for the first half of this year.

**Chart 1: Euro and dollar v renminbi**



Source: Bloomberg.

Politically, China would like the EU to lift the arms embargo imposed since 1989 and to grant it full market status. There is a row over the EU plan to force all airlines using its airports to come into an emission trading scheme which Beijing has rejected. Beijing has been adept at cherry-picking among European countries, and consigns to the doghouse those that receive the Dalai Lama or talk too loudly about human rights or award the Peace Prize to a jailed dissident – the time they have to spend standing in the corner averages two years. For their part, EU leaders generally knuckle under for fear of cutting their exporters out of the Chinese market. This emboldens Beijing to ‘disinvite’ people of whom it disapproves from banquets for visiting European leaders, as it did during Chancellor Merkel’s trip to the Mainland this year.

### **Seeking company**

But the PRC’s main interest in Europe is acquisitions. A highly placed Chinese source made it plain that the aim is not to shore up debt-ridden euro area countries but to buy European companies which have the technology, market share, margins and marketing expertise China’s firms lack. If the crisis makes them cheaper, all the better. Meanwhile Chinese enterprises will move in if European firms withdraw, as shown by the way PRC banks ramped up their agricultural finance in the US when European banks pulled back.

While it ran into choppy waters, the Lenovo-IBM deal remains a template in that respect. Chinese auto makers went into Volvo and Saab not for the European market but for the expertise the Swedish manufacturers possessed. Ditto Sany’s purchase of the German family-owned pump maker Putzmeister. Corporate stakes held by indebted governments are just the ticket, especially when Chinese firms can draw on cheap credit from state banks. With margins tight at home because of price competition or controls, utilities are appealing, for example the purchase of the Portuguese state’s 21% interest in EDP-Energias de Portugal by the Three Gorges Corp. CIC bought into Thames Water because it looked like a solid investment. There have been rumours of Chinese interest in Italy’s ENI and ENEL.

Though the numbers are understated because of funds routed through tax havens, China’s direct investment in Europe more than doubled between 2009 and 2010 to \$6.7 bn. Mainland white goods companies have Europe in their sights. So do high-end medical equipment and engineering firms and companies out to buy energy-efficient and environmentally friendly technology. CNOOC has invested \$300 million in a photovoltaic plants venture with Spanish solar power company Isofoton which is moving manufacturing to Mainland China. And there is always the high-end consumer market; Shandong Heavy Industry diversified by buying a 75% stake in the indebted Italian luxury yacht maker, Ferretti. Expect more acquisitions, if not a ramp-up in bond purchases.

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