

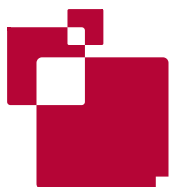
# CHINA AND THE WORLD ECONOMY: A EUROPEAN PERSPECTIVE

JEAN PISANI-FERRY

## Highlights

- Europe is waking up to the economic and geopolitical consequences of China's rise; Europe must strengthen its dialogue with China and focus in particular on the rebalancing of global growth and changes to global governance.
- The rebalancing of global growth is probably the main economic challenge of the next few years. China alone cannot replace the US consumer and the EU is unlikely to provide a strong engine for world growth. But there are topics for Europe and China to discuss, especially how reform can stimulate growth: what would be the global implications of a change in China's exchange rate policy, and how can the transition to a new regime be managed?
- Meanwhile, China's weight and assertiveness in international forums are increasing, and are part of a protracted adjustment of global governance structures to new economic realities. There are both zero-sum and positive-sum dimensions in the EU-China relationship. The priority should be to not let the former dominate the agenda. Both the EU and China must approach the short and long-term issues with more clarity and resolve, in global and bilateral forums.

This paper was prepared for the 'China and the world economy' project and presented at a seminar held in Beijing on 17 November 2009. It draws on comments made by seminar participants. The author is grateful to Ed Lim, André Sapir and Mike Spence for comments on an earlier version. Jean Pisani-Ferry (jean.pisani-ferry@bruegel.org) is Director of Bruegel.



# CHINA AND THE WORLD ECONOMY: A EUROPEAN PERSPECTIVE

JEAN PISANI-FERRY, MARCH 2010

**IT HAS TAKEN EUROPE LONGER THAN THE US** to wake up to the consequences of the rise of China. In the early 2000s, the implications for trade, money and finance were already widely discussed in the US, but the European debates of the time were less sophisticated and less emotional. Consequently, there was much less policy discussion about what Europe expects from China as a partner and as a player in the world economy.

It would be a mistake, however, to conclude from this observation that policy developments in China are less consequential for Europe than for the US, and that China can therefore pay no attention to the evolution of European perceptions and positions regarding its emergence and global role. On the contrary, Europe has many reasons to be attentive to, hopeful for, and sometimes concerned by, the rise of China and its economic and geopolitical consequences. Pisani-Ferry and Sapir (2008) list eight ways in which China's growth will have a clear impact on Europe:

- 1 Europe's industry is at risk of being squeezed between the US and China;
- 2 Dysfunctional European labour markets add to the adjustment cost;
- 3 Chinese integration into the world economy may interfere with the process of European integration;
- 4 Europe's key trade relations are being destabilised by Chinese competition;
- 5 China's efforts to secure access to energy and raw materials impacts on an import-dependent European Union;
- 6 Europe's and China's positions on climate change may result in conflict over greenhouse-gas emission containment and its trade implications;
- 7 The exchange rate of the euro risks being the ultimate adjustment variable;

8. China's rise to world-economic-power status is bound to reduce the Europe's weight in the governance of international organisations.

Pisani-Ferry and Sapir point out that it would be unwise to ignore the challenges that arise from these risks, and the potential roadblocks on the way to the development of smooth economic relations between China and the EU. They recommend that policymakers from both sides should establish a far-reaching dialogue on the possible risks and the appropriate responses.

Building on Pisani-Ferry and Sapir (2008), the aim of this paper is to look ahead and examine what Europe expects from China economically over the next ten years or so. It addresses in turn two issues of particular importance, one of a rather short-term nature and one of a more long-term nature:

- 1 The rebalancing of global growth, and
- 2 The strengthening of global governance.

Both issues are multilateral in essence. However the focus here is on their implications for Europe, China and the economic relationship between them.

## 1 THE REBALANCING OF GLOBAL GROWTH

The rebalancing of global growth is probably the main economic challenge of the next few years. Whereas economists hold different views on the role in the financial crisis of macroeconomic factors in general, and global imbalances in particular, few dispute that the strength and sustainability of global growth will largely depend on the degree to which a rebalancing of global demand takes place (see for a recent discussion Blanchard and Milesi-Ferretti, 2009).

The key question is who is going to replace the US consumer as an engine of growth. From the mid-1990s to at least the mid-2000s, US households contributed strongly to global demand. This has most likely ended, as households have suffered a deterioration of their balance sheets and now need to deleverage and save. True, a large part of the savings adjustment has taken place during the crisis. But public saving will have to increase to reduce the now-huge US budgetary deficit, and this will weigh on domestic demand. So, a major question at G20 level is who, among the US's partners, is going to help offset the corresponding slowdown in global demand.

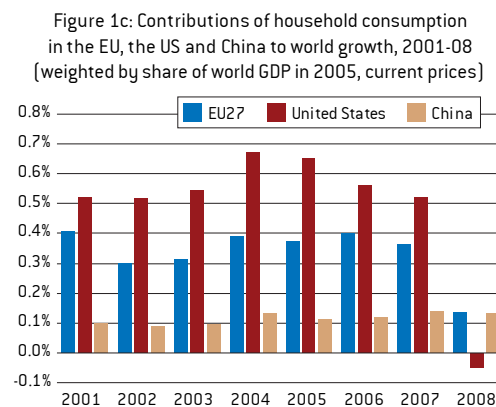
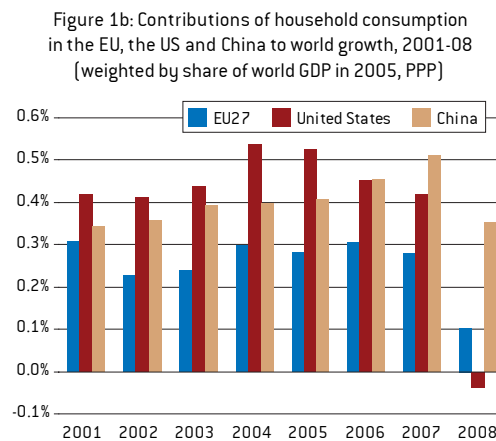
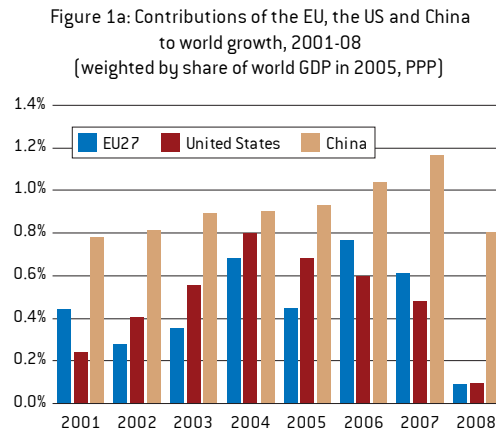
This discussion evidently involves quantity and price dimensions. Although they are two sides of the same coin, it is clearer to address them in sequence.

*i Global demand*

Figure 1 gives the contributions to world growth of both total GDP growth and domestic household consumption growth in the US, the EU and China from 2000-08<sup>1</sup>. It uses three different indicators:

- The contribution of each country or region to global GDP growth, using Purchasing Power Parity (PPP) weights for standard global growth calculations<sup>2</sup>; this indicator shows where growth in the *supply* of goods and services took place, irrespective of where demand came from.
- The contribution of household consumption to global GDP growth, using the same weights as for the first indicator; this indicator represents what the contribution of consumption to aggregate world growth as usually measured has been in each country or region. It can be interpreted as indicating where *demand* has come from.
- The third indicator is similar to the second, but for the country weights. Nominal (current dollars) GDP weights are used instead of PPP weights; this indicator has relevance in terms of market size and the region's ability to generate demand for imports<sup>3</sup>. If Chinese or European consumption is to replace US consumption,

**Figure 1: Alternative indicators of contributions to growth in global demand, 2001-08**



Source: IMF, national accounts, Bruegel calculations.

what matters for any given producer is the dollar amount of consumption they are going to generate. So this third indicator is relevant from a *demand substitution* point of view.

What is striking is how different a picture the three indicators give. From a supply-side point of view

1. Data are 2005 PPP-weighted.

2. Such as, for example, those of the International Monetary Fund as presented in the World Economic Outlook reports.

3. It is not by accident that the same approach is used in the McKinsey report on the Chinese consumer (MGI, 2009).

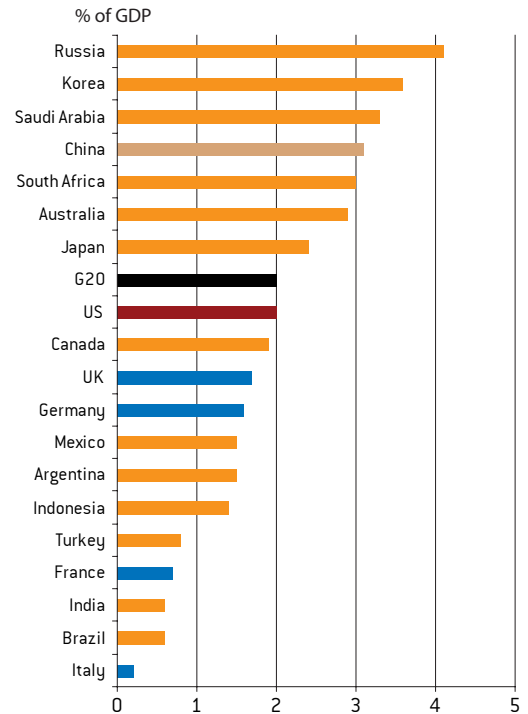
(Figure 1a), China has been the main engine of growth throughout the period. From a demand point of view, the US was the driving force in the first half of the decade, before it was overtaken by China after 2006 (Figure 1b). So it would appear that China's consumption has already substituted US consumption. But if one uses current dollar weights, the contribution of China's consumption has been consistently dwarfed by those of US and European consumption (Figure 1c). From this perspective it would appear that Chinese consumption will not be able to substitute US consumption, even if Chinese consumption grows at a much faster rate.

Figures 1b and 1c appear to provide incompatible pieces of evidence. They do not. The reason why they give such different pictures is that China's share of world current dollars GDP is much lower than its share in PPP dollars GDP. As consumers everywhere primarily consume domestically-produced goods and services, Figure 1b is accurate in describing where the demand driving world GDP growth came from. But when asking whether a one-dollar drop in US consumption can be substituted by a one-dollar increase in Chinese consumption, one must look at Figure 1c.

China certainly has potential for strongly increasing its domestic consumption. The fact that the share of consumption in GDP dropped from 46 percent in 2000 to 36 percent in 2007 provides a strong indication of this potential, and China's partners have every reason to insist that China acts on it. In both the G20 and in bilateral talks, the Europeans will no doubt join the US in asking for Chinese rebalancing towards a more domestically-led, consumer-driven growth pattern.

To a certain extent this rebalancing has already started. For the first time, the emerging countries' relative contributions to the global 2009 stimulus have exceeded those of the developed countries, at least as regards its discretionary part (Figure 2). And beyond the one-time stimulus, a more fundamental and lasting rebalancing in favour of private domestic demand is called for in those parts of the emerging world that have the possibility to

Figure 2: Contributions to the 2009 stimulus by G20 member countries



Source: IMF (Horton *et al*, 2009), Bruegel calculations.

engineer it. China, with its large current-account surplus, as a consequence of an exceptionally high domestic-saving rate, and the potential for a rebound of the share of consumption in GDP, is a prime candidate for a structural, sustained rebalancing of the sources of global demand.

However, the message from Figures 1a-1c is that China *alone* cannot substitute US demand. Other parts of the world must play a role in the rebalancing. What, then, about Europe? Although the EU as a whole, where the current account is close to equilibrium and which did not experience a generalised real-estate boom in the 2000s, does not suffer from macroeconomic imbalance, pessimism prevails as regards its ability to generate domestically led growth. To start with, consumption in the EU is bound to grow slowly as a consequence of the required consolidation of public finances, lingering banking-sector weaknesses in parts of the continent, and the creeping impacts of ageing populations – not to mention the financing strains of Greece and Portugal. In order to stabilise the debt-to-GDP ratios, the European Commission

envisages an average annual structural budgetary adjustment of about one percent of GDP per year for several years from 2011. This is likely to represent for a corresponding period a significant drag on domestic demand growth in the EU.

This implies that the EU is unlikely to provide a strong engine for world growth and might, on the contrary, rely on external demand for the next few years. There are however two caveats. First, situations differ within the EU and even within the euro area. Germany has a large current-account surplus, a relatively moderate budget deficit, stable real-estate prices and a corporate sector whose profitability strengthened in the years preceding the crisis, and is thus in a much better position to exhibit domestically led growth than the UK or Spain, where opposite conditions prevail<sup>4</sup>. Second, even if Europe is unable to engineer a significant expansion of domestic demand, no region can be exempted from contributing to lifting global demand while there are grounds to fear that it will remain weak until the deleveraging process is completed. Europe can play its part by designing a growth programme for the next few years. For maximum impact, Europe should go beyond the structural-reform mantra and select and implement those structural reforms that have the most potential for stimulating demand in the short run, such as pension reforms, green investments and a deepening of EU-wide market integration<sup>5</sup>.

Institutionally, Europe's approach to global discussions is ambiguous. The EU and especially the euro area insist that the bloc should be taken as a whole and that the current-account balances of individual countries are irrelevant. But member states also insist that a number of policy levers such as budgetary policy, tax policy and labour-market policies remain in their hands and that, in international forums, the EU can speak for them only where it has explicit competence. It remains to be seen if, and on what issues, G20 policy

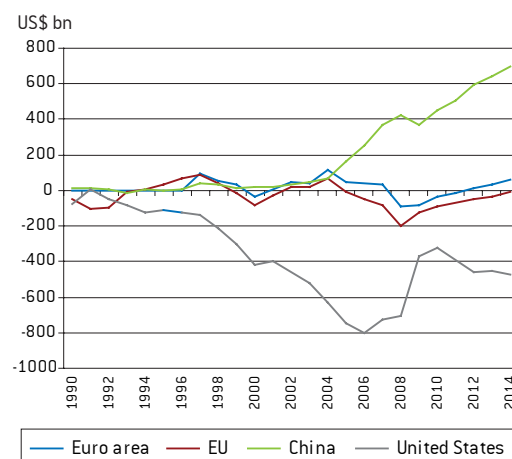
discussions will involve individual countries.

## ii Current accounts and exchange rates

While there are similarities between the US and European situations as regards the outlook for domestic demand, which naturally leads the two advanced regions to express similar preferences for domestic demand-led growth in China, no such similarity exists as regards current accounts. The US and Europe even seem to be in radically different situations: whereas the US economy has recorded persistently high current-account deficits since the early 2000s, and is likely to remain in significant deficit in the years to come, both the euro area and the EU as a whole are close to equilibrium and are projected to remain in this position. China and the US are therefore set to remain in opposite situations (Figure 3), with Europe playing the role of an 'innocent bystander' in what looks like an essentially US-China game.

From this observation it would however be wrong to conclude that Europe is, or can be indifferent to the modalities of current-account adjustment, and more specifically to the ongoing discussion on the exchange rate of the renminbi (RMB). To start

Figure 3: Current-account balances, 1990-2014



Source: IMF World Economic Outlook database and projections.

4. Germany has a weakness, however, in the state of its banking sector.

5. For a discussion of Europe's medium-term priorities see Sapir (2009) and the contribution therein.

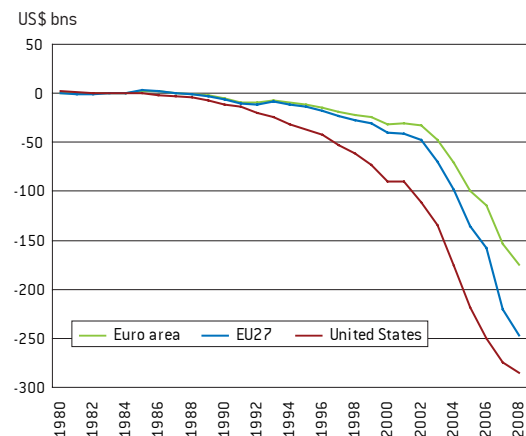
*'Institutionally, Europe's approach to global discussions is ambiguous. The EU insists that the bloc should be taken as a whole and the current-account balances of individual countries are irrelevant. But member states insist that a number of policy levers remain in their hands.'*

with, Europe cannot advocate a rebalancing of Chinese growth towards internal demand while ignoring its exchange-rate consequences. More domestic demand in China has to go hand-in-hand with less foreign demand, which implies a price adjustment. The exchange rate is the variable that can make rebalancing consistent with China remaining on a non-inflationary growth path.

More specifically, there are three reasons why Europe is concerned by China's surplus:

- First, Europe has a bilateral trade deficit with China and this deficit was in 2008 almost as large as that of the US (Figure 4). Whereas bilateral trade balances are irrelevant macro-economically, the imbalanced character of trade with China grabs attention and is therefore important from a political economy standpoint. In addition, current-account balances are very polarised within the EU, with Germany in significant surplus and most other member countries in deficit. Especially, all the other major countries – France, Italy, Poland, Spain and the UK – recorded non-negligible deficits in the years before the outbreak of the crisis (some have temporarily shrunk as a consequence of the recession). While national current-account deficits are of lesser economic importance for the countries participating in the euro, they cannot be overlooked altogether: they are indicators of underlying vulnerabilities and they also matter from a political economy standpoint<sup>6</sup>. They are actually bound to matter more in the aftermath of the crisis than in the years preceding it.
- Second, to the extent that the US dollar needs in the medium term to depreciate in *effective* terms in the context of the rebalancing of US growth, the persistence of a fixed link between the RMB and the dollar leads the euro and other European currencies to play the role of an adjustment variable, which involves the risk of disproportionate appreciation. In other words, for any given effective depreciation of the US dollar, RMB appreciation and euro appreciation are substitutes for one another. In this context the rigidity of the USD-RMB exchange rate,

Figure 4: Bilateral trade balances with China, 1980-2008



Source: Direction of trade statistics.

potentially at least, has detrimental impacts on the exchange rate of the European currencies<sup>7</sup>. This concern has been voiced for some time in Europe but it is of increasing relevance when, as presently, global demand is weak and all countries face the risk of 'competitive depreciation'.

- Third, the evolution of the US-China monetary relationship could also affect the euro through a portfolio channel. As long as the RMB remains in a fixed link with the US dollar, the People's Bank of China (PBOC) will be a large buyer of US dollars assets, thus contributing to limiting the depreciation of the US dollar vis-à-vis third currencies, including the euro. This helps prevent the risk of a major appreciation of the euro vis-à-vis the dollar, over and above the levels reached so far<sup>8</sup>.

This last point suggests that the Europeans could in fact be ambiguous vis-à-vis China's exchange-rate policy. On the one hand, it seems, an appreciation of the RMB would relieve the euro of appreciation pressures stemming from the current account, but on the other hand a move towards delinking the RMB from the USD is likely to imply Chinese reserve diversification into euros and a pressure towards appreciation stemming from the financial account.

From a European point of view this is in fact a genuine intertemporal trade-off. The longer the RMB

6. Whether current-account balances matter within a monetary union has been the topic for an as yet inconclusive discussion. They were generally overlooked during the first decade of EMU while the focus was put on budgetary deficits. However the later experience of some countries such as Spain, whose budget was in surplus while it recorded a current account deficit close to 10 percent of GDP in 2007, has drawn attention to current accounts. They are now considered indicators of the sustainable character of growth patterns and are likely to become the focus of increasing attention in the context of EU surveillance.

7. See for example Ahearne *et al* (2007). For a systematic analysis see Bénassy-Quéré *et al* (2008).

remains in a fixed link with the dollar, the longer large US current-account deficits are going to persist and the larger the net foreign liabilities position of the US economy is going to grow. So the fact that China resists RMB appreciation vis-à-vis the dollar and, even more significantly, the fact that it remains in a fixed exchange-rate regime, may limit euro appreciation in the short run, but at the price of a larger eventual appreciation<sup>9</sup>.

Identifying the most desirable scenario from a European point of view thus depends on time preferences. In a crisis, future benefits tend to be discounted more heavily than in normal times, and – in addition to distractions caused by more immediate concerns – this may explain why in 2008 and in early 2009 the Europeans were not adamant about the need to reform China's exchange-rate policy. But the end of the recession is increasingly focusing attention on the medium term and the need to put world growth on a sustainable path. Europeans have become convinced that the current monetary relationship between China and the US is not sustainable and they are likely to insist more and more that it should be reformed. This suggests that the issue will gain prominence, both in the context of the multilateral G20 discussions that were initiated in Pittsburgh, and in bilateral talks.

An important topic for bilateral and multilateral discussions is the management of the transition to a new RMB exchange-rate regime. Its effect on the euro will depend on the extent and pace of China's reserve diversification, which is a policy variable, and on the way it is communicated to the markets. Europeans have every reason to advocate a very gradual move that would avoid abrupt euro appreciation. This is a topic they are naturally keen on discussing with their Chinese partners<sup>10</sup>.

The current context of euro weakness – as a consequence of concerns over the strength of the euro area and the way it is going to manage possible funding crises within it – paradoxically provides an excellent opportunity for discussions. Unless it is assumed that the euro area will ultimately break-up, which is very unlikely, the

medium-term issues are bound to re-emerge at some point. In-depth discussions held in the meantime would help in addressing tensions when they eventually arise.

## 2 GLOBAL GOVERNANCE

The launch of the G20-summits process and the enlargement of the Financial Stability Forum have accelerated a trend already visible in the rapid strengthening of China's standing in the World Trade Organisation and in international climate discussions, and in the debate over International Monetary Fund governance. Global institutions and global governance forums are in the process of adjusting to the increased weight and assertiveness of China and of the large emerging countries. In fact, this process started in 2003 with the failure of the Cancun WTO ministerial conference, which led the US and the EU to realise that it was no longer enough to reach agreement between them to open the way for a global trade agreement. Further important steps were the first G20 summit in November 2008, and the Copenhagen climate summit in December 2009. At both of these, the main negotiations took place between the US and the BASIC countries (Brazil, South Africa, India and China).

Adjustment of the global governance structures to new economic realities is bound to be a protracted process that will continue through, and beyond, the current decade. How it will develop is of major importance for the EU, China, and their mutual relationship.

### *i Europe's view of the world*

More than any of the other main players, Europeans are natural champions of global governance. They have been practising cooperation through international institutions and shared sovereignty for more than 50 years. These have become part of the EU's genetic code. As pointed out by Robert Kagan (2003), Europeans inhabit a world where the rule of law and the culture of compromise have replaced sheer power, and where large countries have to listen to smaller ones and

8. Another way to say the same thing is that as long as the RMB remains pegged to the dollar and as long as the PBOC intervenes with unlimited funds to keep the bilateral exchange rate stable, the US and China de facto constitute a currency zone, and what matters from a portfolio point of view is the aggregate US-China current-account balance, which has reached a rough balance in 2009 and is moving into surplus. Obviously this view – first promoted in 2003 by Dooley, Folkerts-Landau and Garber – is a simplification, especially because foreign-exchange markets do not assume that the USD-RMB link is a permanent one.

9. A framework for discussing this trade-off is provided by Blanchard, Giavazzi and Sa (2005). See Pisani-Ferry (2007) for a more developed discussion.

10. This remains true in a context in which the euro has been depreciating because of concerns over divergences within the euro area and its internal governance.

find ways to accommodate their concerns. This explains why Europe spontaneously feels at home in the intricacies of multi-level government, why it has such a large stake in the build-up of a rules-based world economy, and why it so often sees itself as a laboratory of global governance.

Furthermore, when European leaders in the late 2000s reflected on the consequences of globalisation for European integration they concluded that the logical implication was that the EU should immerse itself more in the governance of globalisation and play a stronger global role. Unlike the 1960s and the 1970s, when the aim was essentially to integrate behind economic borders, EU endorsement of trade, investment and capital-market liberalisation in the 1980s and the 1990s transformed the EU into a very open economy that could no longer be defined as an inward-looking economic bloc. At the same time, the appetite for political integration was reducing, as indicated by the reluctance to move to full 'political union' in parallel to the creation of monetary union, and by the rejection of the European constitutional treaty in 2005. So in a globalising world, the EU is less and less defined by differential cross-border economic integration, but it cannot count on political integration to provide an alternative identity. What remains is, in large part, an emphasis on shared preferences for the design of global rules. The European heads of state and government thus concluded in 2007 that their aim was to *'[shape] globalisation in the interests of all our citizens, based on our common values and principles'*. They added that *'for this even the enlarged Union cannot act alone'*, implying greater involvement in global governance<sup>11</sup>.

Europe, however, has seen its global economic and political weight erode fast.

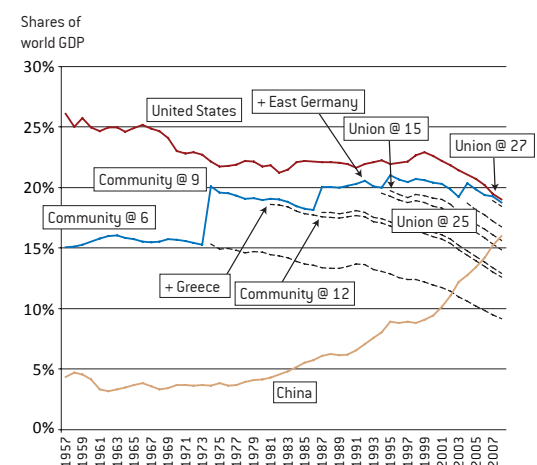
Economically, it is only thanks to a series of enlargements that the EU's share in the world economy has remained roughly stable over four decades at about 20 percent of the total (Figure 5). But barring the – now unlikely – rapid integration of Turkey and Ukraine, the potential for growth by extending the EU's borders has now been

nearly exhausted. As the labour force, and then the total population, start shrinking, the outlook is one of accelerated relative decline in comparison to countries with growing populations and/or a significant potential for productivity catching up. This is even the case if steady productivity improvements are assumed (which have not been forthcoming in the 2000s so far). Europe's relative weight is set to diminish even in comparison with the US, because demographic outlooks differ noticeably. This has little to do with economic success, although under-performance can accelerate the trend. Put simply, even successful mature economies are bound to witness an erosion of their relative power.

Economic trends have had major political consequences already. Although European countries have retained significant over-representation in international economic organisations such as the IMF, the World Bank and even the newly created G20, the widely shared perception in the rest of the world is that time has come for an overhaul. US perceptions and priorities have also changed, as indicated by the evolving recommendations of an influential – and usually timely – Washington voice, C Fred Bergsten:

*'The US and the EU are the world's only economic superpowers. They should form a 'G2 caucus'*

Figure 5: Shares of China, the EU and the US in the world economy



Source: GGDC, Total Economy Database. Purchasing Power Parity GDPs

11. In their 'EU declaration on globalisation', annex to European Council Presidency Conclusions, 14 December 2007.

*which would function as an informal steering committee to manage their own economic relationship and to provide leadership for the world economy.'*

[Bergsten and Koch-Weser, 2003]

*'The United States will need to further develop and nurture special ('G2') relationships in at least four directions: with the EU, with China, with Japan and with Saudi Arabia.'*

[Bergsten, 2005]

*'[China is] a new economic superpower, along with the US and the EU (which, however, speaks with a single voice on only a few issues and thus cannot form a G3 with the other two).'*

[Bergsten, 2009]

The perspective of a world in which Europe does not count enough to be represented at the top table was vividly illustrated at the Copenhagen climate summit in December 2009, when the political agreement that paved the way for the Copenhagen Accord was negotiated between the US president and the leaders of the BASIC countries in the absence of any European representative. This was a traumatic event for Europe, the full consequences of which remain to be seen.

## ***ii China, Europe and global governance: zero-sum game dimensions***

Facts are stubborn and it is best not to ignore them. China's rise is a real challenge to Europe's role in, and views on, global governance. Pure zero-sum-game dimensions do exist, where China's growing influence and assertiveness contribute to diminishing those of Europe, and are therefore perceived as a threat. These dimensions need to be identified, potentially divergent interests need to be acknowledged, and disagreements have to be addressed. At the same time there are positive-sum-game dimensions that must equally be recognised and on which cooperation can be built.

The zero-sum dimensions first arise from the objective factors listed in the previous section. Europe's global power, its role as a strategic economic partner of the US, and its say in global governance, are bound to diminish while China's are bound to increase. Part of the problem is that, as history abundantly shows, incumbent powers hang on to the weight and influence they once had and are in no hurry to relinquish them. China and other emerging countries have every reason to insist that significant adjustments need to be made to the governance of international organisations and, whatever they may say in public, Europeans know that these adjustments are long overdue.

But the problem also has more subtle aspects, to do with internal EU governance: the major European countries value their individual representation in international organisations and are reluctant to relinquish it. A Europe whose share in these organisations were reduced to, say, one-fourth of seats and votes instead of one-third currently, would remain very powerful<sup>12</sup>. In fact it would be nominally more powerful than the US today. But to exercise this power effectively, Europe would have to unify its representation and therefore to put in place internal-governance mechanisms that would ensure effective decision-making on external matters. This is by no means a fantasy – it is already the case for international trade, for the international aspects of competition policy and, for euro-area countries, for exchange-rate policy. Meanwhile, proposals for strengthening common external economic representation have been discussed extensively<sup>13</sup>. But national governments are reluctant to transfer representation to the European Commission or another body. External procrastination thus reveals uncertainty and disputes over internal governance, making Europe less able to adjust to the rise of China<sup>14</sup>.

A second, more profound, dimension relates to

12. See Ahearne *et al* (2007) for an overview of Europe's weight in international organisations. The one-third proportion also applies to the G20.

13. The new 'Lisbon treaty' governing the EU includes a clause that would allow unified representation in international economic and financial organisations.

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*'China's rise is a real challenge to Europe's role in global governance. China's growing influence and assertiveness contribute to diminishing those of Europe, and are therefore perceived as a threat. Divergent interests need to be acknowledged, and disagreements have to be addressed.'*

attitudes towards global governance. Political scientists often characterise Europe as 'post-Westphalian', meaning that the traumas of European wars have led citizens, and their governments, to shun nation-state assertiveness and embrace supranational governance. Furthermore, as endorsement of global rules has more than occasionally been a way to resolve internal disputes, the EU as a consequence sees the strengthening of global governance and the strengthening of its own internal unity as mutually reinforcing<sup>15</sup>. Europe in this respect is very different to both China and the US, where, obvious differences apart, the structure of domestic power does not bode well for the multiplication of binding external commitments and where willingness to accept encroachments on sovereignty is in consequence limited. China especially has much less experience of participation in international arrangements and as a still-developing country, it does not have an abundant supply of internationally-trained civil servants to take part in a multiplicity of often highly-technical simultaneous international negotiations. Furthermore, it sees such existing international arrangements as a way of preserving the global status quo and thus EU/US power, at the expense of developing countries. China is therefore naturally wary of the very same complex web of international agreements and institutions that Europe regards as the best possible guarantee of its own future prosperity.

For this reason, China's rise (as well as India's and those of other emerging powers) represents not only a quantitative change. Qualitatively, it may also shift the balance away from the global governance-oriented agenda the Europeans are pushing for, and bring back to the fore a more traditional, cruder and more nation-state-centric view of international economic relations.

The Copenhagen climate summit was typical in this respect, with Europe on one side coming to the conference having already given binding commitments and willing to enter into further commitments on condition that partners joined it in proportionate efforts. On the other side, the US and China came to Copenhagen with different

objectives but both were reluctant to go beyond limited, and, de facto, not really binding commitments. The near-failure of the summit was regarded in Europe as a major setback and as a sign of the difficulty of reaching agreement on the global governance agenda advocated by the Europeans. While they blamed China less than the overall negotiation framework and the attitude of a small number of countries that made any formal agreement impossible, the broader concern is whether global governance can deliver as much as Europe expects.

The degree to which China will be willing to engage in, and develop ownership of, global governance will be crucial in determining Europe's attitudes towards it. Europe still hopes that China will actively take part in international discussions and contribute to writing global rules. It admits that this will require significant adjustment on its side because it cannot expect China to underwrite the rules already decided on by the US and Europe. But it also fears that China's 'realist' approach to international relations will dash its own hopes of the emergence of a post-Westphalian world.

There are other areas in which Europe and China can be portrayed as competitors, such as access to natural resources and associated partnerships with third countries. As an energy-poor and natural-resources-poor region, Europe especially is fearful of terms-of-trade losses triggered by China's fast-growing demand for primary goods. This is unavoidable and there is little China can do to appease European fears.

However there is significant room for improvement in one respect: China's eagerness to enter into a series of bilateral agreements with resource-producing countries suggests that it regards bilateralism as a better guarantee of economic security than multilateralism. True, it is not China that invented bilateral agreements. But the combination of apparent lack of trust in multilateralism and an apparent trust in bilateral deals is easily perceived by Europeans as a threat to the type of international relations they have confidence in. This applies notably to Africa where, as traditional

14. These issues are discussed in Coeuré and Pisani-Ferry (2007).

15. This may in fact be disputable as global governance is in some respects a substitute for European governance.

patron and former colonial master, a now resource-poor Europe is disturbed by China's growing interest in securing access to natural resources. But the issue is broader and, although interests differ, discussions and compromises are possible.

### *iii China, Europe and global governance: positive-sum game dimensions*

The existence of zero-sum-game issues should not lead us to overlook positive-sum dimensions.

A first, and important, dimension that has potential implications for a wide range of policy areas, is a shared preference for economic multipolarity. Throughout the post-second world war era, Europe has been a junior partner to the US, with whom it had much in common but whose occasionally unilateralist tendencies regularly caused concern. The emergence of a new power, whose economic weight is about to match that of the US and the EU, represents an opportunity to renew pleas for a more balanced world. This especially applies to 'winner-takes-all' issues, such as international money and global regulation, where the dominant power tends to have disproportionate influence in comparison to its immediate followers. Here, Europe may see in China's rise an opportunity for a more balanced structure of power in which it could play a bigger role. By the same token, China, which has been a consistent advocate of multipolarity, could see in Europe a partner with which it could cooperate in the shaping of a new global architecture.

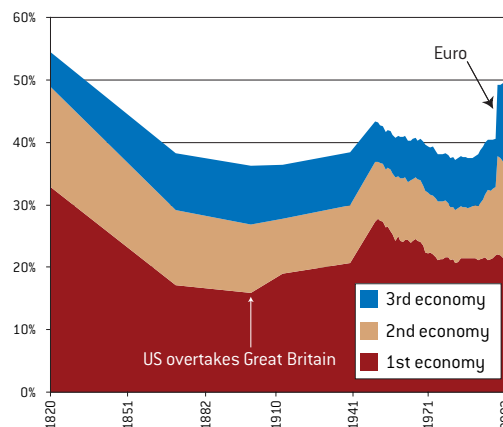
This is not to say that Europe and China should form an alliance to unsettle US power. US economic and financial predominance is bound to remain unchallenged for several decades. However the emergence of a more even balance of economic power, where the weight of the predominant country is diminished in relative terms, calls for changes in the de facto structure of global governance and leadership.

This is especially apparent for monetary relations. The dollar has played an overwhelming leadership

role until now, but there will be a growing mismatch between the size of the dominant economy and the role of the dominant currency. As Figure 6 indicates, the share of the main international currency-issuing economy in the world (the US) in comparison to the shares of the next two economies (currently China and the euro area) is already lower than when sterling was replaced by the dollar as the main international currency. It is bound to decline further and faster. This is indicative of the increasing fragility of an arrangement that relies for the supply of the international currency on an economy that is getting weaker in relative terms.

Scholars of international monetary relations often refer to 'hegemonic stability' theories, according to which international monetary stability is best guaranteed by assigning a leading role to the largest country. The rationale for this view is that a dominant power is in a position to internalise international 'externalities' while this is more problematic in a competitive arrangement (see Kindelberger, 1973, and for a critical discussion Eichengreen, 1987). It is hard to speak of hegemonic stability, however, when the hegemon's objective power base shrinks. When this happens, the country issuing the international currency may be tempted to exploit this advantage to its own profit, rather than to ensure global stability. In other words, while hegemonic stability may imply that it is better to have the world run by one

**Figure 6: Weight of major currency-issuing economies, 1820-2005**



Source: Maddison, Bruegel calculations. PPP GDPs.

hegemon than by rival powers, this does not imply that in a situation where economic power is more evenly distributed, it is better to stick to hegemonic arrangements.

While there is no direct rival to the dollar yet, our analysis suggests there is a potential for the gradual emergence of a multi-currency system in which the euro and presumably also the RMB, or a future common Asian currency, will play significant regional roles and share with the dollar some international-currency functions<sup>16</sup>. From a European point of view, China's rise is an indication that, in future, the euro, which is currently a distant second international currency, is unlikely to remain alone in its dialogue with the US dollar, and can become a building block for the monetary system of the future. From a Chinese point of view, the existence of the euro portends the eventual emergence of a more balanced multi-currency world.

A second positive-sum-game dimension arises from a shared interest in regional cooperation. Europe has long experience of regional arrangements, the main result being today's EU. China has embarked on cooperation with neighbours, primarily within the framework of the ASEAN+3 forum, and it shares with them a desire to strengthen regional cooperation in the economic, financial and monetary domains. East Asia in general is wary of multilateral intrusions into areas of

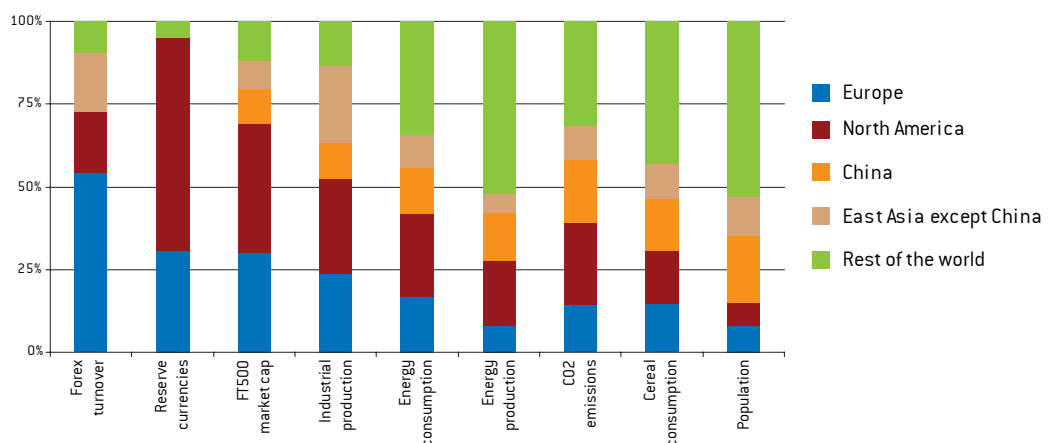
traditional national sovereignty and is more sympathetic to regional initiatives – as illustrated by the attempt to create an Asian Monetary Fund in the late 1990s and by the subsequent Chiang Mai initiative.

How and to what degree multilateral and regional arrangements can be made compatible and mutually consistent is a major issue for global governance. Trade specialists have discussed this for a long time, as trade is the field where regionalism first started to have an impact. But the question also arises in the context of G20 discussions, where EU authorities intend Europe to take part as a single entity but lack the means to speak in the name of all Europe. It also arises about the Europeans' reluctance to let the IMF intervene within the euro area to assist countries in distress such as Greece, while at the same time the EU has no mechanism of its own that can substitute the IMF. Europe's experience in this respect is of interest for Asia, and both regions can also help trigger an international discussion on the multilateral response to the regional challenge.

#### *iv China, Europe and the US*

In the light of the preceding analysis, there is a risk that the EU and China could attempt create rival G2s with the US. An implication of China's developing-country status is that its objective weight in the world economy varies considerably

**Figure 7: Measures of relative economic power; shares of China, North America and Europe in the world, selected indicators, mid to late '00s**



16. Pisani-Ferry and Posen (2009) discuss how a combination of economic, governance and geopolitical factors explains why the euro is not yet a rival to the US dollar.

'Source: Bruegel, BIS, IMF COFER, FT Global 500, UNIDO, UNEP, IEA, FAO, The Conference Board and Groningen Growth and Development Centre

depending on the area, as imperfectly captured by simple comparative indicators (Figure 7). China is heavyweight enough in some fields for no meaningful international agreement to be possible without it (this is for example the case for trade and greenhouse-gas emissions). But in other fields China is a lightweight, and remains a junior partner compared to the US and Europe (this is the case for financial regulation, competition and still – though less and less – for product standards).

Europe therefore could easily liaise with the US to retain and exercise leadership in areas in which China is still a junior power, while China could liaise with the US to gain and exercise leadership in areas in which it has become a more significant player than Europe. This might appear to be a natural outcome, but it would be one in which the potential for EU-China cooperation would not be exploited.

### 3 CONCLUSION

The preceding analysis shows that in the coming decade the economic rise of China is likely both to generate friction with Europe and to create potential for fruitful cooperation. The question for policymakers on both sides is how to prevent

zero-sum dimensions from dominating and running the show. This requires high-quality dialogue that acknowledges the potential for friction while emphasising the potential for fruitful cooperation.

The current level of dialogue does not meet this standard. On macroeconomic issues, Europe has become more consistent, but the stance taken by its representatives is not always backed by the constituent member states, and the EU too often pretends it is not really part of the solution to the current macroeconomic dilemmas. Meanwhile, China tends to procrastinate instead of defining its medium-term macroeconomic strategy. On governance, it is the Europeans who procrastinate and display inconsistency, while China fails to spell out what its conditions are for developing genuine ownership of, and confidence in, the global-governance institutions. On both sides, it is high time to approach the short- and long-term issues with more clarity and resolve.

Discussions within international forums such as the G20 as well as bilateral consultations offer an opportunity for improving the quality of the dialogue and making sure it focuses on issues of major bilateral and global relevance. These opportunities should be seized.

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