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Can China rescue Europe?

The debt crisis in Europe is no longer a European affair. Coupled with fears of a double-dip recession in the United States, the European debt crisis is dragging the global economy into another cycle of financial panic and economic recession.

Sitting on the sidelines, emerging-market economies in general, and the so-called BRIC countries (Brazil, Russia, India, and China) in particular, may feel fortunate to be spared this financial maelstrom. But they should think again. With closely integrated global financial markets and trading networks, financial crises and economic contractions in the developed economies, which still account for nearly 60% of the world's GDP, will inevitably undermine emerging-market countries' prosperity.

Some have thus called upon major emerging countries to step up and use their huge foreign-exchange reserves to purchase the debt of crisis-ravaged countries, such as Greece, Italy, and Spain. In particular, China, with its $3.2 trillion in foreign-exchange reserves, is seen as a potential white knight coming to the rescue of debt-ridden European nations.

Playing upon such hopes, China has been both coy and demanding. Without committing itself to any substantive assistance, the Chinese government has publicly demanded that the European Union grant China the coveted status of "market economy" if it expects China to loosen its purse strings. That status matters because achieving it will make it more difficult for Chinese firms to be found guilty of dumping goods on overseas markets.

Unfortunately, those who expect China to play a direct role in calming the financial panic in Europe are being unrealistic. Chinese leaders have been extremely risk-averse in their forays into

international financial affairs, and, on the eve of a leadership transition (expected to take place a year from now), no senior official dares to risk his political prospects by advocating bold and controversial action. Even assuming China's willingness to help Europe's troubled economies, it would be able to contribute only a modest portion of the huge amount of financing required to restore confidence in European sovereign debt.

But this does not mean that China can do nothing to help Europe. While the attempt by Chinese officials to extract a huge concession - market-economy status - is ill-timed and in poor taste, China's government needs to weigh the significant benefits that it could receive by providing limited but meaningful assistance to Europe in its hour of need.

Indeed, to do so would be in China's own interest as a key stake-holder in Europe's economic stability. The European Union is China's largest trading partner, accounting for $383 billion in merchandise exports in 2010. So a recession in Europe would cause a slowdown in China's export-dependent economy as well.

The financial fallout from the debt crisis could also result in huge losses for China. About $800 billion of China's foreign-exchange reserves are invested in euro-denominated assets. A disorderly default, and the resulting downward pressure on the euro, would unavoidably cause Chinese investments to lose value.

China can take three measures to help Europe, but, if they are to succeed, the EU must set aside some of its long-standing suspicions about China. First, China can help boost the EU's exports by lowering its administrative trade barriers to products from the EU. In the short term, this might dampen China's own growth, but, given China's mammoth trade surplus with the EU ($230 billion in 2010), this is both long overdue and reasonable. A 10% increase in the EU's exports to China (a net increase of $15 billion a year) would help create at least 300,000 jobs and boost Europe's growth prospects.

Second, China can participate in bank recapitalization in Europe. At the moment, Europe's banks desperately need to shore up their balance sheets. China's sovereign wealth fund and non-bank financial institutions have been eager to invest in well-established Western banks. This is a good time to do so, as these banks' valuations have plunged.

Finally, Europe's crisis presents an attractive opportunity for China to expand its direct investment there. In 2010, Chinese direct investment in the EU totaled only $1.3 billion. Today, when governments and companies in Europe are opening their arms to foreign investors, Chinese companies eager for markets, technologies, and diversification should find rich pickings.

But Chinese money has been viewed with suspicion in Europe, reflecting fears that China has a hidden political agenda. Such bias has discouraged Chinese capital from making bigger bets on Europe. It is now time for Europe to gamble on China.

Such measures are likely to boost Europe's medium-term growth prospects. While they would most likely have no immediate calming effect on today's panic-stricken financial markets, they are far superior to watching with folded hands as Europe descends into a financial abyss.

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