Greece-Proofing China

Despite repeated assurances by European Union leaders, after more than two years, there is still no light at the end of Europe's debt-crisis tunnel. Recently, the president of the European Commission, José Manuel Barroso, referring to a possible Greek exit from the eurozone, told the European Parliament that there is no "Plan B."

Illustration by Newsart

Barroso's statement was meant to be reassuring. But, after so many disappointments, China cannot accept at face value the assurances of European politicians, which even they themselves do not know whether they can redeem. China should have its own Plan B in case Greece has to leave the eurozone.

Indeed, it is increasingly likely that Greece will renege on its bailout obligations. If that happens and the "troika" (the European Commission, the European Central Bank, and the International Monetary Fund) cuts off financial support, Greece's exit from the euro will become all but inevitable. In that event, China must be prepared for any ensuing global financial turmoil and longer-term consequences.

For starters, Chinese officials should be under no illusion that the country will be immune to financial contagion. A "Grexit" would hit European banks that hold peripheral eurozone countries' sovereign bonds. Shock waves from the deleveraging would, in turn, spread to emerging markets like China.

banking-sector assets is negligible, post-Grexit capital flight from risky markets could rival, or even surpass, that in the weeks following Lehman Brothers' collapse in September 2008. Compared to 2007 and 2008, foreign investors' holdings in emerging markets are much higher, owing to these countries' relative economic strength in recent years and rock-bottom returns on developed-market financial assets.

In fact, China already experienced the impact of deleveraging late last year, when the European financial system seemed on the brink of collapse. With European banks hunkering down, the renminbi's exchange rate fell for 11 consecutive days, even though China was running a current-account surplus.

The performance of emerging-market currencies and other assets so far in the second quarter suggests that deleveraging has begun once again. Disappointing first-quarter growth data have already led foreign investors to have second thoughts about keeping money in China. A Grexit could prove to be the last straw, and would surely lead to a tightening in domestic monetary conditions at a very precarious point in the economic cycle.

As such, the timing could not be worse to float the idea of speeding up capital-account liberalization. On the contrary, the Peoples Bank of China (PBoC) and other relevant authorities should consider capital controls, market suspensions, and emergency liquidity provision.

These measures are not dissimilar to those that the eurozone will pursue if Greece exits. Ideally, the response would be coordinated with China's international partners in the G-20. The infrastructure for such cooperation has developed strongly since 2008, and China must not shy away from advocating its deployment.

Moreover, China must have a medium-term plan to deal with the economic aftermath of a Grexit. Should contagion prove to be limited, with Greece the only casualty, the drop in eurozone output may be severe, but not catastrophic. Nonetheless, the EU is China's most important trading partner, and China must be braced for serious job losses in the export sector.

Japan's experience shows that a recession that results from a financial crisis can be extremely prolonged, because deleveraging is a long process. It is highly likely that today's recession will drag on for many more years in both America and the EU. So China's government must have a medium- and long-term plan to address problems caused by a drawn-out global slump.

The problems include a surge in unemployment, and the need to reallocate fiscal resources to these individuals, whose welfare is critical to the preservation of social stability. More importantly, the Chinese government should not retreat from efforts to implement structural reforms aimed at shifting China's growth model to one that places much greater emphasis on domestic demand.

In addition, net foreign capital inflows are likely to dwindle for several quarters at least, affecting domestic monetary conditions while aggregate demand is weak. As such, the PBoC will need to maintain counter-cyclical policies in order to avoid a deflationary spiral.

Although bound to be controversial, especially in an election year in the United States, enough flexibility should be given to the renminbi in both directions when it is needed. One of the biggest failures of the eurozone periphery is a loss in competitiveness, hidden by a wall of credit that has been leveraged from Germany's balance sheet. This is always unsustainable. Any loosening by the PBoC should not be used to avoid painful structural reforms.

Finally, China should be ready to extend a helping hand. To ensure that the post-Grexit eurozone's integrity faces no further immediate threats, China must join international partners in establishing a fully credible firewall, via the IMF. However, the eurozone, and Germany in particular, must fully acknowledge the fundamental causes of Greece's exit and pledge to move towards fiscal union, while acknowledging that an austerity-only approach towards other at-risk members is a dead end.

An adequate firewall and a European commitment to structural reform would go far toward calming markets and reducing the risks to any Chinese contribution. In other words, any assistance that China provides must be "throwing good money after good potential results."
Of course, IMF governance reform will also need to be part of the discussion. Meanwhile, the eurozone will likely be more open to foreign investment out of necessity, and cash-rich Chinese companies should continue to pursue opportunities via FDI or corporate acquisitions.

A potential Grexit will present entirely new challenges to China in the coming months, and the country must avoid complacency over its own exposure. A battle plan for both the present and the future is needed now.

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