China: Europe's White Knight or Economic Black Swan?

Arguably the biggest economic story over the past three decades has been the economic modernization of the People's Republic of China. Since 1980, China's GDP has increased thirteen-fold, while its share of world total GDP has increased from a scant 2.2% in 1980 to approximately fifteen percent today.[1] China produces roughly half of the world's total cement and consumes twice as many barrels of oil a day than Japan.[2] And today, it stands as the world's second-largest economy, and is the largest foreign creditor of the United States.[3]

China's use of capital controls, a managed nominal exchange rate, repressed domestic consumption, and low labor costs have allowed it to become one of the world's leading exporters. The byproduct of China's export-led growth has been the accumulation of foreign exchange reserves, concentrated heavily in U.S. dollars.[4] Currently, China has approximately $3.3T in currency reserves, most of which is invested in long-term U.S. treasury bonds and agency debt.[5]

China's lack of foreign exchange diversification, coupled with ongoing economic travails in Europe's sovereign debt crisis, has led some observers to believe that China is currently facing a logical choice: it can diversify its foreign exchange holdings and also be a savior of the global economy by using its considerable financial clout to purchase sovereign debt of the so-called "PIIGS" countries in the Eurozone, including Portugal, Ireland, Italy, Greece, and Spain. Doing so might be in China's interest, since a timely and sizable investment in European markets could help China achieve the tripartite goals of stabilizing the global economy, gaining preferential access to European markets, and diversifying its foreign exchange holdings.[6]

The goal of this brief is to analyze whether China has both the means and desire to use its cache of currency reserves to contribute to a European bailout fund. This report suggests that although it is possible that a large financial commitment to the Eurozone on behalf of China's State Administration of Foreign Exchange (SAFE) and the People's Bank of China (PBoC) could help lower peripheral European borrowing costs, China will be reluctant to use its reserves for that purpose. In fact, instead of being an economic savior of Europe, China is more likely to be a potential source of the next shock to global capital markets.

China's Foreign Exchange Reserves

Before explaining China's options about what to do with their foreign exchange holdings, it is helpful to consider how they accumulated their reserves in the first place. As shown in the foreign exchange flow chart in figure 1, China earns foreign exchange reserves through its goods and services exporters, which are then deposited in China's onshore banks. The PBoC then purchases these deposits from China's banks. Recall that all other things being held equal, surplus balance of payments economies will eventually experience a combination of nominal

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exchange rate appreciation and domestic inflation because of this mechanism, thus eroding trade competitiveness and balancing international balance of payments accounts over time. To prevent this natural correction, the PBoC engages in currency intervention in their domestic and international capital markets, using their currency, the renminbi, to purchase U.S. dollars.[7] PBoC dollar purchases put upward pressure on the dollar-renminbi exchange rate, depreciating the renminbi relative to the dollar. China then engages in open market operations to prevent domestic monetary expansion from leading to domestic inflation.

While China gains export competitiveness from this policy of dollar recycling, it accumulates dollar denominated assets along the way. This relationship is borne out by data compiled by the Congressional Research Service in figure 2, which shows that China's current account balance closely mirrors their annual change in foreign reserves. As of March 2012, China has accumulated approximately $3.3 trillion currency reserves (see figure 3 for the change in currency reserves over time). China invests a large proportion of these currency holdings in U.S. securities, including U.S. Treasury debt, U.S. agency debt, U.S. corporate debt, and some U.S. equities (figure 4). China is both the biggest foreign holder of U.S. securities and the largest holder of foreign exchange reserves in the world (figures 5 and 6). China currently owns about 25% of all U.S. foreign-held debt today, and about 5% of total U.S. debt securities.

China's enormous exchange rate revenue sits parked in low-yielding, dollar-denominated assets. As such, it is undiversified, insofar as a majority of China's exchange rate revenue is held in dollars, and unhedged, since China cannot protect the value of its foreign exchange from depreciation in the dollar relative to the RMB. Indeed, domestic inflation in the United States, coupled with depreciation of the dollar exchange rate, devalues China's currency holdings over time. And, China's gradual steps to diversify its holdings to be less dependent on the dollar via selective sovereign wealth investment have earned mixed returns.[8]

In short, China currently sits on a veritable war chest of foreign exchange earnings, most of which are denominated in U.S. dollars. Given this large material capability to deploy capital worldwide, this brief now examines whether China could use its reserves to help solve the sovereign debt crisis in Europe.

Could China 'Save' the Eurozone?

European leaders recognize that China's large currency holdings make it a possible candidate to contribute to peripheral European bailout funds. Former French President Nicolas Sarkozy reached out to his Chinese counterpart, Hu Jintao, to gauge China's interest in contributing to a Eurozone bailout fund – something that brought Sarkozy much criticism at home.

At market exchange rates, China's some $3.3T in dollar reserves amounts to approximately €2.6T. Since a large portion of China's currency holdings are tied up in U.S. securities, China's investable portion of currency reserves amounts to approximately €1T. As shown in figure 7, a 35% financial commitment of the Chinese to the so-called "PIIGS" countries, including Portugal, Ireland, Italy, Greece, and Spain, would cost approximately €1.17T.[9] At the very minimum, China could use its considerable financial clout to finance large portions of each country's budget deficit, thereby providing flow financing for new debt, as opposed to purchasing off-the-run debt securities (stock financing). But such a strategy – China selling dollars to purchase

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peripheral debt – has two potentially confounding implications that could complicate such a strategy's effectiveness.

First, China's announcement to purchase tranches of European sovereign debt could cause the Euro to appreciate relative to the dollar, thus decreasing the potential purchasing power of China's dollar reserves. Upon China's announcement of its purchasing European debt, many investors would purchase Euros and sell other currencies in anticipation of China's Euro purchases. As a result, China's purchasing power of Euros in dollars might fall, potentially dulling the effectiveness of their asset purchases. There might be ways around this: China could try to complete these agreements in secret, at pre-determined exchange rate values. Moreover, China could allow peripheral European states to issue U.S. dollar or Reminbi-denominated bonds. But in either case, to be fully effective, any Chinese purchase of peripheral European debt would have to be accompanied by some combination of complex financial engineering and market subterfuge.

Second, China's announcement could also considerably boost investor confidence in the financial markets. In general, the ongoing sovereign debt travails of peripheral European countries reflect an overall lack of market confidence in sovereign borrowers. A large Chinese financial commitment to peripheral Europe could increase the *perceived* creditworthiness of peripheral borrowers, in turn causing their interest rates to fall. In fact, the mere announcement of China's intent to purchase sovereign debt in Europe could cause peripheral bond yields to fall, thereby easing their funding pressure without China having made a single transaction.

In sum, the effect of Chinese sovereign debt purchases would be moderately positive for peripheral borrowers. Adverse exchange rate movements would likely be outweighed by boosted market confidence and the fact that the Chinese still maintain considerable buying strength despite worsening terms of trade. China's announcement to purchase assets in peripheral Europe could cause other market participants to attempt to "front-run" Chinese asset purchases, lowering peripheral bond yields, and dimming the prospects of wholesale financial collapse in the periphery.

Why China Would Save the Eurozone

There are several reasons why China would commit a sizeable portion of their currency reserves to a European bailout package.

First, China, more than most countries, relies on a stable global monetary and trade order for its own internal security. The Chinese Communist Party (CCP) requires high growth rates to raise China's living standards and keep itself in power. The entire edifice of Chinese growth is built on a foundation of stable financial markets and China's access to global markets. Multiple sovereign defaults across the European continent could hurt global growth, lowering China's export revenue and potentially causing economic contraction in China.[10] Furthermore, a renewed global recession could cause multiple countries to engage in beggar-thy-neighbor trade and currency policies, further exacerbating an already tepid economic recovery. As economic historian Charles Kindleberger argued, failed economic and monetary stability vis-à-vis the global liberal trading order during the Great Depression prolonged global economic stagnation and laid the groundwork for fascism across Europe. No doubt that Chinese leaders are aware of

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this history lesson and would see European defaults catastrophic to the international economic order upon which their entire growth project rests.[11] It would not be unreasonable to see China try to calm markets using their currency reserves to protect the fragile stability of the global economy.

Second, China could see this period of European weakness as an opportunity to gain access to heretofore closed European markets. Long-standing U.S. and European laws prohibit Chinese investment in trade markets like aerospace, defense, and other sensitive technology industries. It is possible that China could seize this moment of crisis to offer Europeans an offer they cannot refuse: lift trade restrictions in exchange for Chinese bailout money. Doing so would confer a large strategic advantage to China, while also adding to global economic stability.[12]

Third, China could use its currency reserves and status as one of peripheral Europe's top creditors to buy healthy European companies and expand the worldwide reach of China's multinational corporations, many of which are state-run. In May 2012, China Investment Corporation (CIC), China's sovereign wealth fund, established a private equity fund to invest in European companies. CIC also has plans to launch similar funds with BlackRock, a large asset management firm, and recently formed a joint fund with the Russian government in October 2011.[13] Chinese firms want to purchase global businesses for usual business reasons, like acquiring favorable relationships with raw materials suppliers, gaining access to technology, and increasing their access to foreign markets. Using their vast currency reserves to provide sovereign debt relief to peripheral Europe could pave the way for a wave of Chinese acquisitions of European companies.[14]

Fourth, there is convincing *realpolitik* logic to China's bailout of peripheral Europe. Scholars such as the Peterson Institute's Arvind Subramanian have claimed that China's vast currency reserves put it in prime position to force the United States into unfavorable security arrangements out of economic necessity. China's ascendency, which Subramanian calls "imminent," will allow China to dictate economic and security policy to the West. Subramanian further contends that China could set conditions upon its continued investment in U.S. Treasury bonds, calling for or requiring a withdrawal of the United States' navy in the Western Pacific.[15] While such a China-triumphalist view tends to diminish and ignore the real fault-lines facing China's economy (see below), the fact remains that there is a strong *realpolitik* rationale for China to come to Europe's aid: by serving as the guarantor of Europe's economic stability at a time when America is both unwilling and potentially unable to do so, China could conditionalize its continued support of peripheral European debt on Europe's rejection of American forward deployment, for instance. In a world of open hostilities between China and the U.S., China could use its financial leverage in Europe to pry core American allies out of alliances like NATO, further diminishing America's influence worldwide. While such scenarios appear far-fetched, no doubt military strategists in both China and the United States are aware of this potential.[16] In either event, bailing out Europe could provide China with another valuable chip in this contest for international supremacy, potentially earning China some much-needed "soft power" in Europe, in turn brandishing China's image abroad.

Fifth, it would make sense for China to diversify its currency holdings to avoid putting all of its "eggs in one basket," as Lu Feng of Beijing University's China Macroeconomic Research Center

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put it. Chinese Premier Wen Jiabao claimed "Europe is a main investment destination for China to diversify its foreign-exchange reserves." Such a move makes sense: China sits idly while its vast dollar reserves depreciate with monetary stimulus in the United States. Some scholars, such as Eswar Prasad at the Brookings Institution, argue that China should adopt an aggressive diversification strategy to buffer itself against downturns in the value of the dollar. Contributing to a European bailout program could help China diversify its currency holdings while also achieving the above goals.[17]

Bigger Problems at Home

Although there are a number of potential benefits to China for contributing to a bailout of peripheral Europe, there are several reasons why China might prefer to keep their reserves denominated as dollars to hedge against the potential of an economic downturn at home. This is the lesson that many developing countries learned during the Asian financial crisis of the late 1990s: other things being equal, a central bank should have a ready stock of currency reserves to buffer your currency against capital outflow. If China were to experience a hard economic landing, then, these currency reserves could provide the People's Bank of China with valuable ammunition to support the value of the RMB in foreign exchange markets should many foreigners "rush to the exits" and remove their investments from China at the same time.

While bailing out peripheral Europe could benefit China, the domestic political considerations of China's authoritarian rulers could prevent China from using its vast currency reserves to save Europe. To understand why China might view its currency reserves as a hedge against capital outflow, it is important to analyze issues in the context of the key decision-makers in China: the Chinese Communist Party (CCP). In general, the best way to understand China's future behavior is to ask whether the CCP will benefit from a particular course of action.

How China uses its vast currency reserves, which China's citizens see as the people's savings, is a politically contentious issue in China. With foreign currency reserves amounting to approximately $2,000 per Chinese citizen, or roughly one third of China's per-capita income, Chinese citizens view China's currency reserves as the fruit of China's collective hard work and industrialization. Where the CCP allocates these reserves is a politically sensitive issue to the Chinese. For this reason, it might be a safer bet for the Chinese to bide their time with their currency reserves, since some domestic political constituents could see China's attempt to bail out Europe as a frivolous luxury that China cannot afford.[18]

While there are many forces behind China's economic modernization, one of the key features of China's reform period from 1980 to present has been the CCP's disciplined strategy of buying the loyalties of business interests and bringing them into the Party structure. By integrating China's enterprising citizens into the Party and then placing them at the commanding heights of China's large state-run corporations, the CCP has diminished the potential of internal dissent from China's enterprising class – typically a key driver of political reform during authoritarian transitions. [19]

There are, however, several threats, or economic fault lines, inside of China that threaten the economic stability of the country and, in turn, the Party's hold on power. For example, China faces a potential infrastructure bubble in both residential real estate and transportation sectors. A

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burst of this bubble caused by a lack of demand for new homes could cause a cascade of economic pain across the Chinese economy, potentially inducing foreign investors to withdraw their capital from China. This would, in turn, have several implications for the Chinese economy, outlined below.

Construction Employment: Construction investment accounts for approximately twenty percent of total Chinese employment. Furthermore, construction workers tend to be the least educated and most rural members of the Chinese workforce, and could thus be the hardest hit by a fall in home prices. Currently, real estate prices have fallen to a sixteen-month low in May. While China's housing prices are not collapsing, even the best-case scenario of home price stagnation could prove disastrous for China's labor demand, much of which is based upon the implicit assumption of rising prices for home construction.

Loss of Savings and Financial Weaknesses in State-Run Banks: Additionally, falling home prices could serve as an adverse shock to consumers, since financial repression in China has limited the number of investment destinations for Chinese savings. A fall in home prices could erase a large portion of China's savings base at a time when Chinese consumers have to deal with rising general inflation and a fall in export growth.

Falling home prices can also hurt China's state-run banks and other industries that rely on foreign financing, either in the form of foreign direct investment or hot capital flows. China could thus use their vast currency reserves to stem the tide of capital outflow, should rising non-performing loans and failing business cause foreign investors to pull their money out of the Chinese economy.

In addition to the three factors listed above, China must also contend with several long-term structural challenges, including income inequality and increasing China's national innovation capacity. Surely the CCP is aware of the potentially destabilizing effects of long-term inequality in which half of China enjoys living standards comparable with many Western counterparts and half maintains living standards akin to some of the poorest states in the world. Additionally, Chinese planners are aware of the possibility of falling into the middle-income trap, wherein a state, having achieved a certain level of development, stagnates because it cannot rise up the value chain of production. As a result, China has been rapidly trying to make investments to bolster their national innovation capacity. Both of these issues – rising income inequality and improving their national innovation capacity – could prove decisive in determining whether China cements its great power status or suffers a hard economic landing from which it will take many years to recover. China's vast currency reserves provide a strong cushion against these factors.[20]

Conclusion

The People's Republic of China has made extraordinary gains over the last thirty years and bears many trappings of a great power. Yet observers should not overestimate China's ability to solve the advanced-industrial world's problems. China's internal power dynamics and bursting real estate bubble, coupled with long-term demographic and structural economic challenges, will prevent it from outright "saving" the Eurozone. Despite the hype surrounding China's international diplomatic and economic overtures, the fate of China will be determined more by

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its own internal growth engine than strategic foreign investments. This is something about which the CCP is acutely aware, and for this reason, China will more than likely choose to use its currency reserves as a hedge against internal recession than as a tool of external speculation. For now, China is less likely to be a white knight for the Eurozone than a black swan to the global economy: a large, under-anticipated fault line facing the world's fragile recovery from the global financial crisis.

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Appendix

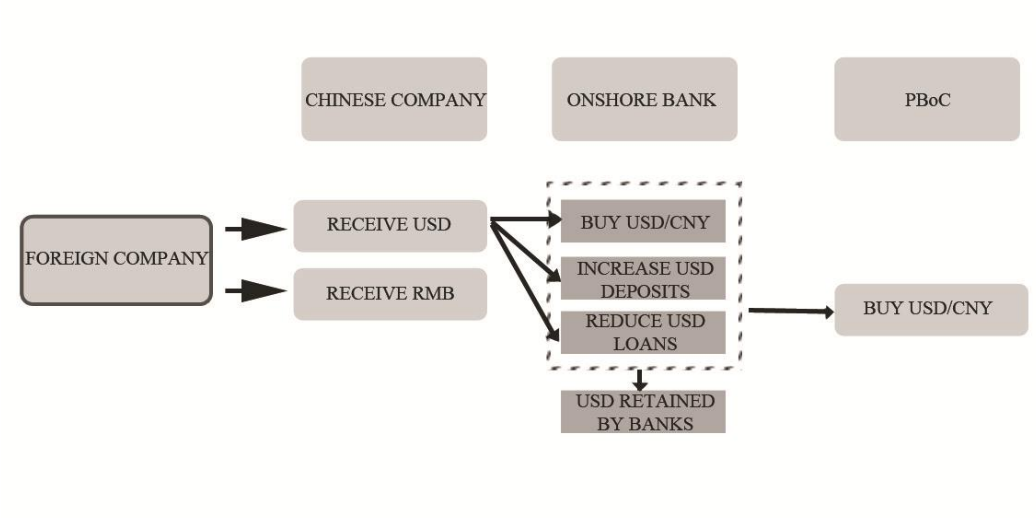

Figure 1: Sources of China's Foreign Exchange Revenue (Chen and Lin 2012)

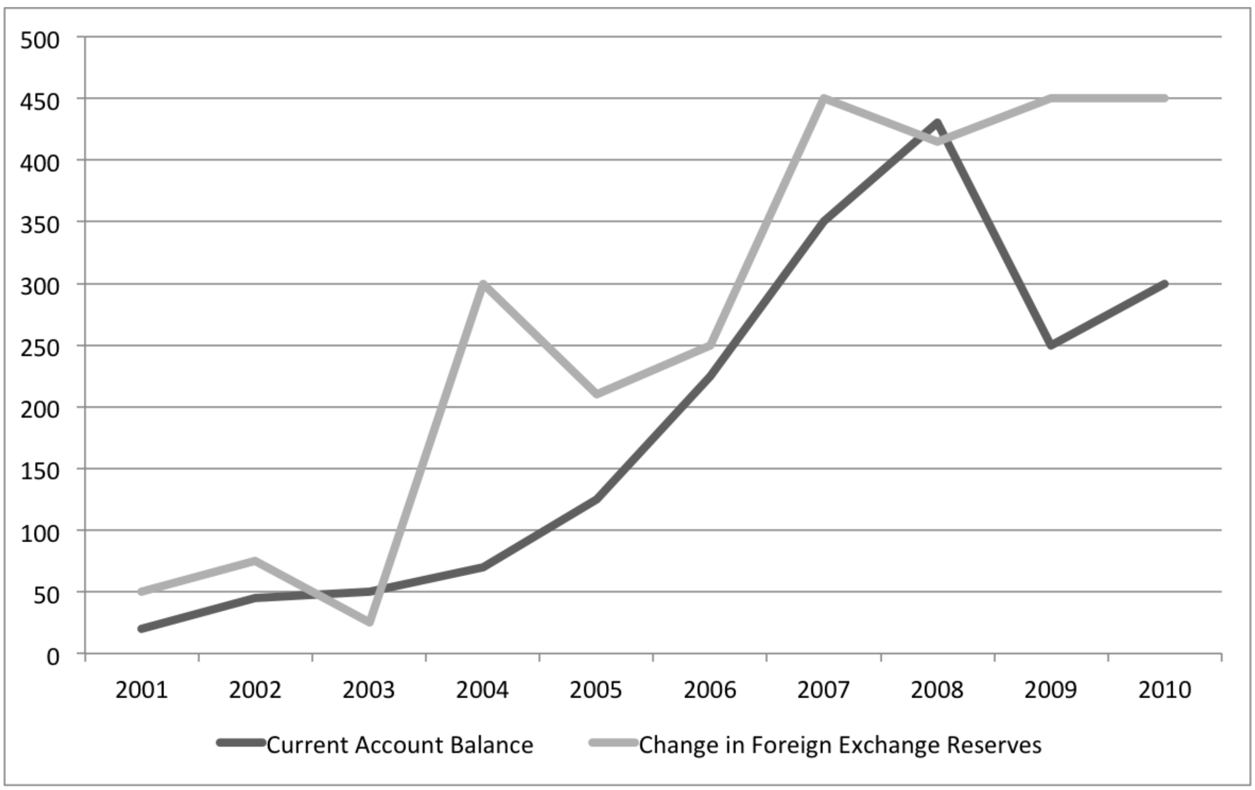

Figure 2: China Current Account Balance and Annual Change in Foreign Exchange Reserves: 2001-2010 (Congressional Research Service)

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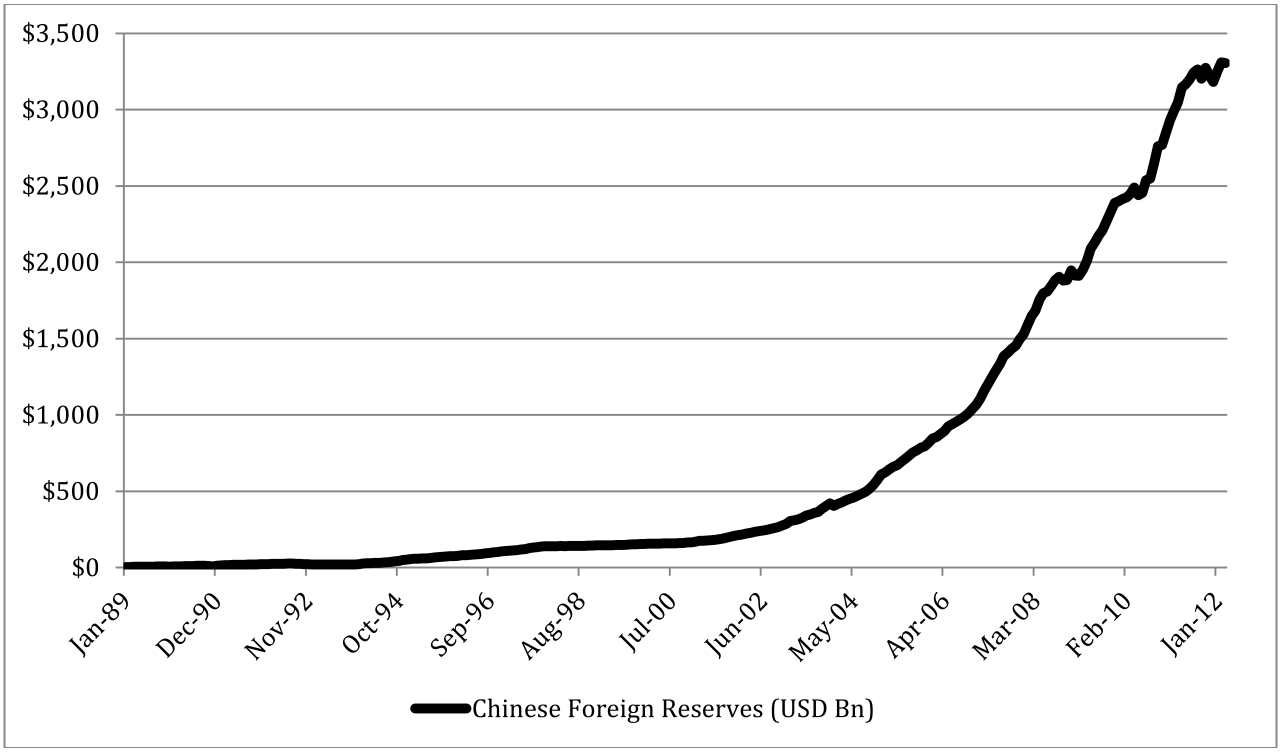

Figure 3: Chinese Foreign Exchange Reserves (People's Bank of China)

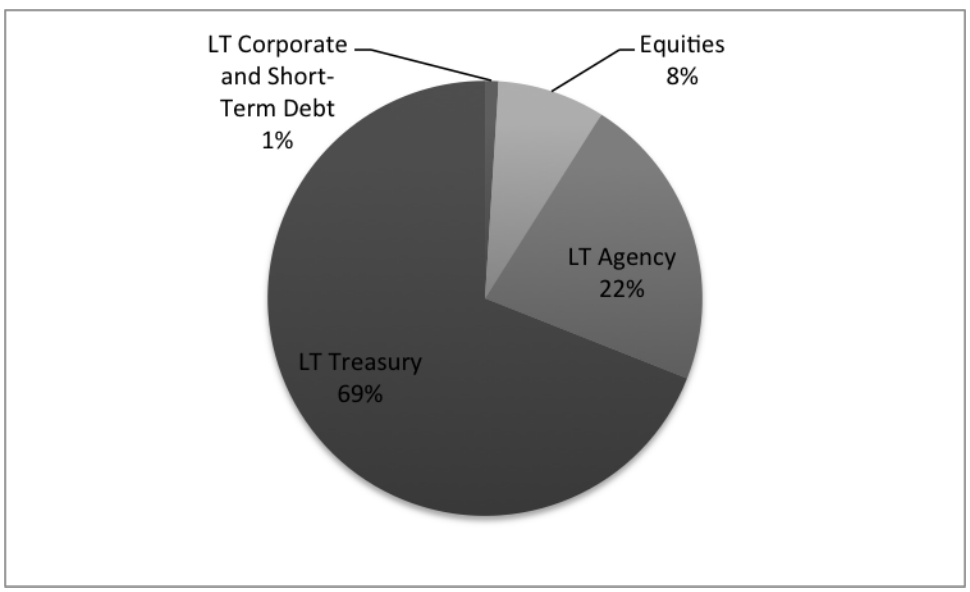

Figure 4: China's Holdings of U.S. Securities (% total holdings) (Congressional Research Service)

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Country	Total Foreign Holdings	Country Holdings as a Share of Total Foreign Holdings
China	1165.5	25.9
Japan	911.0	20.2
United Kingdom	349.4	7.8
Oil Exporters	229.6	5.1
Brazil	207.1	4.6
Taiwan	153.4	3.4
Caribbean Banking Centers	140.5	3.1
Hong Kong	118.4	2.6
Russia	109.8	2.4
Switzerland	108.2	2.4
Total Foreign Holdings	4499.2	100.0

Figure 5: Largest Holders of U.S. Securities (Congressional Research Service, U.S. Department of Treasury)

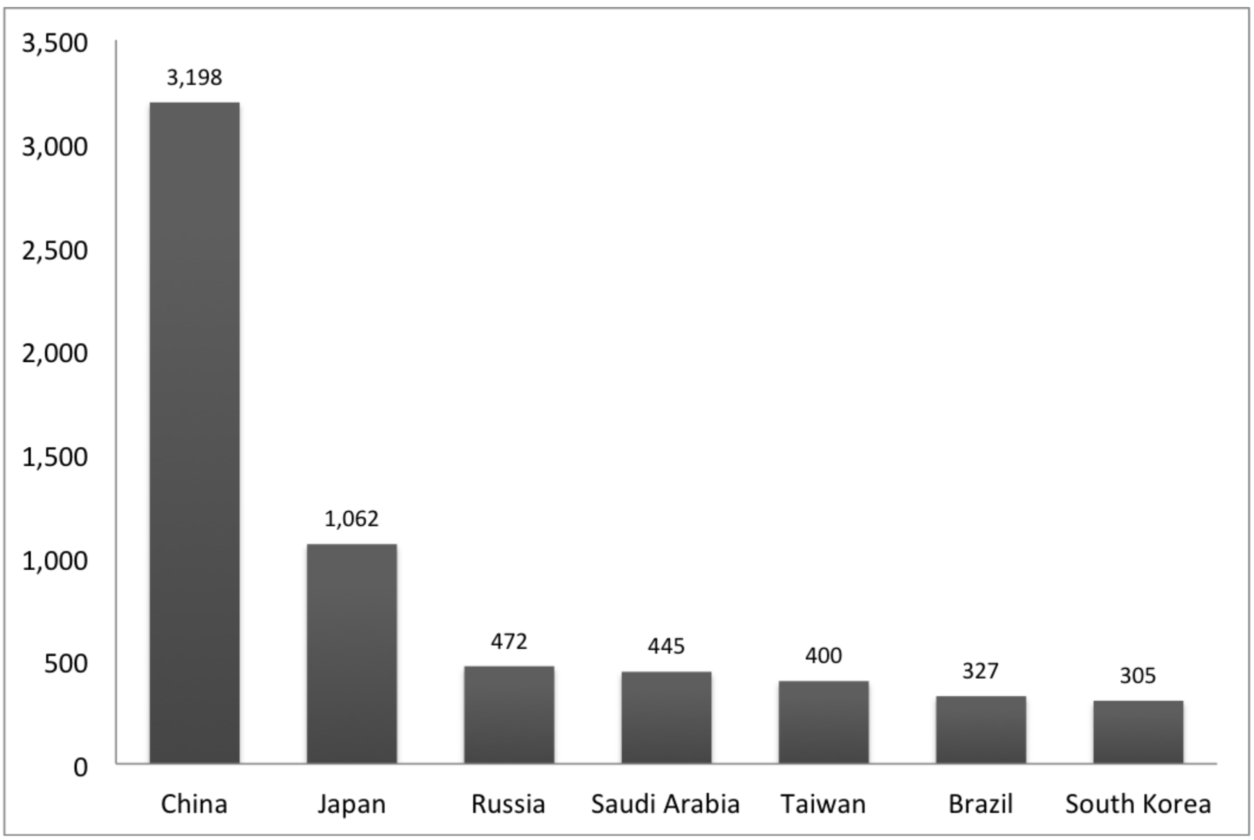

Figure 6: Largest Holders of Foreign Exchange (Congressional Research Service)

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		Commitment Level			
Country	Total Sovereign Debt (€Bn)	10%	20%	35%	50%
Portugal	184.29	18.43	36.86	64.50	92.15
Ireland	169.26	16.93	33.85	59.24	84.63
Italy	1,897.18	189.72	379.44	664.01	948.59
Greece	355.62	35.56	71.12	124.47	177.81
Spain	734.96	73.50	146.99	257.24	367.48
Total:	3,341.31	334.13	668.26	1,169.46	1,670.66

Figure 7: Peripheral Sovereign Debt Loans (€Bn, est. 4th quarter 2012) (Wall Street Journal)

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