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Report

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➤ China's Approach to US debt and the Eurozone crisis

Nicola Casarini

The sovereign debt crisis and the economic predicament of the West elicit mixed feelings and attitudes in China. On the one hand, the spiralling debt and worsening market conditions of the US and the eurozone are affecting China's export-driven economy significantly; on the other, the crisis in the West provides Beijing with the opportunity to raise its profile internationally and challenge the existing international economic and monetary order. China's financial resources are sought after, both to contribute to solving the eurozone's debt problem and to continue sustaining the America's structural deficit. Beijing has protected its position as the largest investor in US treasuries by disinvesting away from dollar-denominated assets and increasing its holdings of the euro. Risk in the eurozone has been offset by reallocating Chinese purchases of bonds away from peripheral countries and into the core members, in particular Germany. Moreover, China has increased its investments in European industrial and infrastructure projects that guarantee safer returns. The debt crisis is changing global power relations: Chinese leaders are today, for the first time in modern history, in the position to take advantage of the West's economic woes while also lecturing American and European policy makers on their economic and fiscal policies.

CHINA AND US DEBT

Since the beginning of the subprime mortgage crisis in 2007 and following the collapse of Lehman Brothers in September 2008, Beijing has closely monitored the state of the US economy, China being the largest foreign investor of US treasury bills and other US securities. In Autumn 2010, China's Dagong Global Credit Rating Company decided to downgrade the US to A+ (4 levels lower than AAA) when the US Federal Reserve decided to continue its policy of quantitative easing. In Chinese eyes, this is essentially a way for the US to print money, with the associated risks of debasing the currency and setting off inflation in emerging markets. With this debt monetisation and its zero interest rate policy, the Fed is in reality devaluing the US dollar, making it easier for the US to service its debt. This forces foreign investors like China to keep rolling over debt to avoid realising currency losses on their investments.

Since Beijing holds a significant amount of US government debt it risks suffering major losses as a result of any dollar depreciation. These investment losses would limit the financial flexibility of China at a time when it is most needed for rebalancing its domestic economy and growth model. The damage could also lead to political instability, as the Chinese blogosphere is fiercely critical of the central government and its management of China's foreign reserves.

Furthermore, low interest rates and the falling US dollar have encouraged investors to increase investments in emerging markets, which offer better returns and higher growth prospects. These flows have pushed up asset prices and currency values, distorting economic activity and leading to inflation in China. The People's Bank of China has had to intervene several times in recent years to increase interest rates and restrict bank lending.

A weaker dollar allows the US to regain its competitiveness by making its products cheaper. Yet this seems to have helped America's exports and growth only partially. US debt has continued to increase in the last few years, raising further doubts about Washington's capacity to service it in the future. These concerns were highlighted on 5 August 2011 when Standard & Poor's downgraded the US sovereign credit rating by one notch from AAA to AA+. The other two major rating agencies, Moody's and Fitch, maintained America's AAA rating. Following Standard & Poor's' downgrade, the Chinese Dagong subsequently further lowered the US to a single A, indicating heightened doubts over Washington's long-term ability to repay its debts. Dagong has also downgraded Germany, France and the UK, assessments not shared by the major Western credit rating agencies.

Standard & Poor's justified its downgrade by citing 'political brinkmanship' in the US debate over the debt ceiling, as well as concern about the federal government's ability to manage its finances in a stable, effective and predictable way. The planned \$2.1 trillion in budget savings 'fell short', according to Standard & Poor's, of what was required to reduce the nation's debt to more manageable levels. This assessment was largely shared by the Chinese government, which is increasingly worried about the security of Chinese savings massively invested in US treasuries and other US dollar securities.

What worries China is that recent US economic growth has been debt-fuelled. Since 2001, borrowing has contributed to around half the recorded economic growth in the American economy. By 2008, \$4 to \$5 of debt was required to create \$1 of growth. A reduction in debt reduces growth, which in turn makes the level of borrowing more difficult to sustain. China, as the major investor in US government bonds, finds itself in the position captured by John Maynard Keynes: 'Owe your banker £1000 and you are at his mercy; owe him £1 million and the position is reversed.'

A MARRIAGE OF INTEREST: FOR HOW LONG?

After the US downgrade in August 2011, the Chinese government issued a statement indicating its hope that 'the US government will earnestly adopt responsible policies to strengthen international market confidence, and to respect and protect the interests of investors'. The People's Bank of China continues to purchase US government debt as part of a giant global liquidity scheme. Chinese foreign reserves have been growing from dollars received from exports and investments that had to be exchanged into local currency. In order to avoid increases in the value of the renminbi that would affect the competitive position of Chinese exporters, Beijing has massively invested its reserves in US dollar-denominated assets, primarily US Treasury bonds and other high-quality securities. Until summer 2011, China typically purchased around \$1 billion of US Treasuries a day. In this way, China has been fuelling American growth by both supplying cheap goods and providing cheap funding to finance the purchase of these goods. It has been a mutually convenient alliance of interests: China has financed customers creating demand for exports and America has received the money to buy Chinese goods. But following the worsening of the global financial crisis, Chinese worries about the sustainability of US debt have increased, leading the Chinese government to diversify risk away from the dollar. After US downgrade in August 2011, the *Xinhua* news agency called explicitly for an end to American hegemony over world markets and for international supervision of US printing of new dollars. It went further to argue that China 'has every right now to demand the US address its structural debt problems and ensure the safety of China's dollar assets', maintaining that America needs to cut 'its gigantic military expenditure and bloated social welfare costs' to cure its budget deficit.

A solution to America's debt problem is indeed to bring the federal budget deficit down, through spending cuts, tax increases or a mixture of both. In 2011, the major categories of government spending were defence (24 percent), social services (44 percent), non-defence discretionary (25 percent) and interest (7 percent). The US defence sector captures almost a quarter of the federal budget, which is largely financed by foreign investors like China. Ironically, it is toward

Beijing that the US military is now turning its attention. Chinese concerns about the US debt crisis coincide with Washington's worries about Chinese military modernisation which are leading the US to overhaul its security posture in the Asia-Pacific.

On 5 January 2012, President Barack Obama and Leon Panetta, US Secretary of Defense, released the new Strategic Guidance, maintaining that the US military 'will of necessity rebalance toward the Asia-Pacific region'. This is in keeping with the broader 'pivot' toward the Asia-Pacific, illustrated by Barack Obama's trip to the region in November 2011, as well as progress toward the Trans-Pacific Partnership (TPP) economic agreement and plans to rotate US military forces through bases in Australia, moves that many Chinese analysts have interpreted as aimed at countering China's growing power and influence. The new Strategic Guidance reflects a commitment to maintain the US military's ability to operate effectively in the region and to continue to act as the guarantor of Asia's public goods and security. However, the US strategic pivot toward the Asia-Pacific makes China's bid for regional hegemony impossible. America's new defence posture thus prepares for eventual hedging activities against Beijing, should China's assertiveness and newly-acquired capabilities be used to undermine US strategic interests in the area. It may only be a coincidence, but China's diversification of its foreign reserves, which began in earnest after the US downgrade in August 2011, has accelerated in recent months following the announcement of the US pivot to Asia and the issuance of the Pentagon's Strategic Guidance clearly aimed at keeping Beijing in check. China's holdings of US treasuries at the end of January 2012 were \$1.156 trillion, or 23 percent of total US treasuries, down of more than 5 percent from 28.2 percent in July 2011.

AWAY FROM THE DOLLAR

According to data released in March 2012 and published in the specialised press – including The Wall Street Journal and the Financial Times – while overall foreign demand for dollar securities has remained strong, the percentage of dollar holdings in China's foreign reserves has fallen to a decade-low of 54 percent in 2011 from 65 percent in 2010. Purchases of US securities accounted for just 15 percent of the increase in China's foreign exchange reserves in the 12 months, down from 45 percent in 2010 and an average of 63 percent over the past five years, according to information published by the US Treasury and the Chinese government.

This trend runs counter the approach adopted by the other world's major central banks. According to a poll by Central Banking Publications – a London-based company that specialises in reporting on central banks – the portion of allocated reserves held in dollars rose from 60.5 percent in the second quarter of 2011 to 62.1 percent by the end of the year while the portion of central banks' (excluding China) allocated reserves held in euros fell from 26.7 percent to 25 percent over the same period, results that are supported by IMF data. In the same period, however, the portion of the People's Bank of China's (PBOC) allocated reserves held in euro-denominated assets rose from around 27 percent to 33 percent. This indicates that China is adopting a contrarian strategy – compared to the other major central banks – to aggressively diversify its reserve portfolio away from the dollar. This trend confirms Chinese Premier Wen Jiabao's declarations that the euro is currently the prime target of China's purchases. The numbers above are significant in as much as Beijing has accumulated the world's largest foreign reserves (around \$3.3 trillion at the end of March 2012).

The main beneficiary of this diversification strategy has therefore been the euro, which now accounts for around one-third of China's foreign reserves, up six percent from summer 2011. There has been a reallocation, though, of Chinese purchases of eurozone bonds, away from peripheral countries such as Portugal, Ireland, Italy, Greece and Spain and into the more secure core members of Germany, France, Austria and the

Netherlands. This is in line with the statement issued by Zhou Xiaochuan, governor of PBOC, on 12 March 2012, about the need for Beijing to make continued efforts to manage the country's reserve assets with 'new ideas' and in a more 'effective' manner. In other words, China will continue to diversify its investments in foreign bonds away from the US dollar and into the more secure (i.e. AAA-rated) eurozone's core members, while keeping risk control a top priority. China seems to put more trust in Europe's economy – in particular Germany – than in the US. This is also reflected in trade patterns: EU-China bilateral trade is growing at a sustained pace, with Sino-German trade alone surpassing €100 billion in 2011.

A strong euro benefits China's export-driven economy by putting downward pressure on China's currency, and is instrumental for lessening the predominant position of the dollar. Furthermore, the US pivot to the Asia-Pacific and the new defence strategic guidance clearly aimed at Beijing are pushing Chinese leaders into multiplying the diversification of its economic and political interests – and connections – to hedge against an eventual US-led encirclement strategy. In this vein, the diversification of Chinese foreign reserves away from the dollar and into the euro also includes elements of support for the EU and its integration process as a counterbalance to America's primacy.

CHINA AND THE EUROZONE'S DEBT CRISIS

Chinese leaders have approached the eurozone's sovereign debt crisis through the lens of their long-standing support for a stronger and more united EU that could work alongside Beijing to counter American hegemony, including challenging the dollar's 'exorbitant privilege'. China has supported plans for a European single currency since the beginning, as part of its desire to create an international currency system where the dollar would be less dominant. In 2009, the PBOC governor explicitly called for the creation of a new international reserve currency. In the meantime, for Chinese policy makers the euro represents the strongest alternative to the dollar, with Beijing having been one of the first buyers of the new currency, starting a process of diversification of its reserves that continues today.

It is in this context that China has voiced concerns about the eurozone's sovereign debt crisis. The EU is China's most important export market, and since the mid-2000s, China has been the EU's biggest source of imports. In 2011, EU-China trade amounted to €428 billion, yet the economic downturn in Europe is seriously affecting the Chinese manufacturing sector. It is therefore in China's interest to continue sustain the value of the euro, since by doing so, it keeps the value of the renminbi down, thus helping the competitiveness of Chinese products.

The survival of the euro is also politically crucial for China's multipolar strategy. Chinese officials have intervened on a number of occasions since the beginning of the eurozone's debt crisis to reassure markets and the Europeans that they will continue to buy eurozone bonds. Chinese investors, for instance, have continued to represent a strong proportion of the buyers of the Portuguese bail-out bonds being auctioned by the eurozone's €440 billion rescue fund, and Beijing has also showed an interest in investing in fully guaranteed and safe (i.e. AAA-rated) eurobonds once they become reality.

This continued interest in euro-denominated assets should not be interpreted, however, as an endorsement of how Europe has been handling the debt crisis in some eurozone countries. The primary motivations lie in finding new, safe investments into which to put China's growing reserves, sustaining its most important export market, and diversifying risk away from the US dollar. Beijing has agreed in principle to participate in the international efforts aimed at solving the eurozone's debt crisis, a promise that Chinese leaders reiterated in 2012, during the visit of Angela Merkel to China in early February, on the occasion of the EU-China Summit on 14 February, and the visit of Mario Monti to Asia at the end of March. Yet, no official commitment has been made as to the amount that China is ready to make available for the eurozone's rescue fund through the IMF.

Moreover, Chinese leaders have attached some conditionality to their participation in any solution of the eurozone's sovereign debt problems, reiterating its demand that the EU 'puts its house in order'. In September 2011, Wen Jiabao also indicated that the granting to China of Market Economy Status

(MES) and/or lifting the EU arms embargo would be regarded favourably by both Chinese leaders and citizens and thus help support China's bailing out of rich Europe. In practice, China's contribution, rather than simply bailing out the eurozone, has taken the form of growing investments in industrial assets and infrastructure projects across Europe.

Analysts at Grisons Peak Merchant Bank found that Chinese FDIs in the EU have soared by 297 percent in 2010 (compared to 2009) to reach \$2.13 billion. Europe is proving more fertile ground for Chinese investments than the US: China's total investments in Europe are 53 percent greater than the \$1.39 billion that went to the US in 2010, according to the Chinese Ministry of Commerce. However, the amounts invested so far come to less than 5 percent of China's global overseas foreign direct investment. Chinese purchases in Europe are likely to expand in the future as the debt crisis in some eurozone members provides investors with lucrative opportunities. To this end, in March 2012 the Chinese government injected \$30 billion into the China Investment Corporation (the Chinese sovereign wealth fund) to be used specifically for acquiring industrial and strategic assets in Europe.

THE PROPENSITY OF THINGS

China's economy is suffering as a result of the debt crisis in the US and in the eurozone. Yet Chinese leaders have also succeeded in turning some of the elements of the crisis to their advantage. China's strategy of diversifying its foreign reserves away from the dollar and into the euro contributes to China's long-term goal of lessening the dominant position of the dollar to create a multipolar currency system, in which the renminbi will also have a role to play. At the same time, China's support for the eurozone and growing investments in Europe allow Beijing to obtain valuable technology, knowhow and brands, to be used to further the country's economic modernisation and development. This differentiated approach toward the US and the eurozone's debt crisis appears in line with the Chinese traditional concept of *shi* – to exploit the propensity of things in order to achieve the desired goal. ■