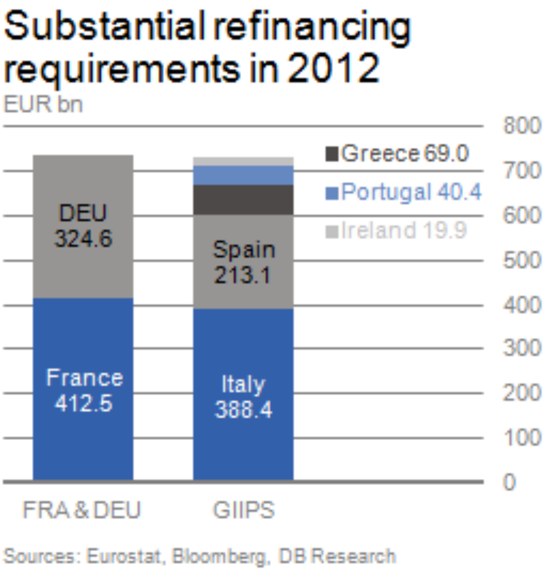
Talking point

China – Not really a white knight for the eurozone

September 16, 2011

Recent media reports put a lot of emphasis on the role China could play in assisting to resolve the eurozone debt crisis. In our view, however, hopes pinned on China might be overdone. The amount needed when looking at estimated refinancing needs for 2012 is huge, amounting to EUR 730 bn for the GIIPS countries. Even if China were willing to increase its investments in euro assets a realistic number would be around EUR 150 bn for 2012. Risk aversion coupled with potentially hostile domestic public opinion make substantially increased – and unconditional – Chinese investment in the eurozone unlikely in the near term.

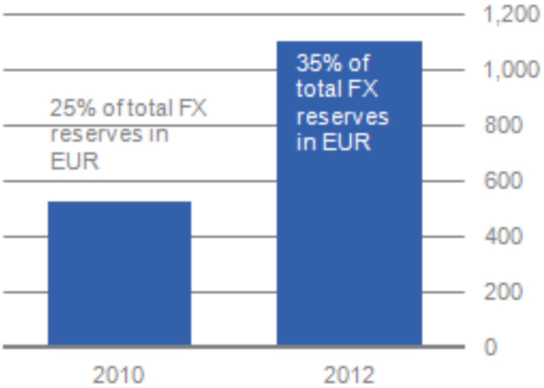


What are the motives for China?

The eurozone is China's most important trading partner. The region takes up around 20% of China's total exports, which is slightly higher than the US share in Chinese exports. From this angle, China has a vital interest in a stable eurozone, as exports (and export-related investment) account for a substantial share of GDP growth and – what is probably even more important – employment. Estimates show that Chinese export growth could drop by 6-7 percentage points (pp) and real GDP growth by 1 pp in case GDP growth in the US and EU slowed by 1 pp.* Furthermore, China is already invested in euro assets. According to various estimates, around 20-25% of China's total foreign currency reserves or EUR 480-600 bn are held in euro assets, presumably predominantly in highly rated sovereign instruments like German Bunds. In addition, investors from China (incl. Hong Kong) bought 6% of the EUR 5 bn initial issuance of the EFSF benchmark bond in January 2011. China has a stock of EUR 7 bn in foreign direct investments in the eurozone (3% of its total outward FDI stock as of 2010). Last but not least, the euro is part of China's envisaged tripolar world order – i.e. co-existence of the US dollar, euro, and Chinese yuan as three leading global currencies.

How much assistance would be needed from China?

The eurozone as a whole needs around 17.5% of estimated GDP for refinancing** in 2012, equivalent to EUR 1.7 tr. The largest share is by France with around 25% of the total, followed by Italy with a share of almost 23%. Spain, Greece, Portugal and Ireland together make up another 20% or EUR 340 bn. Together, the five GIIPS countries will probably need EUR 730 bn in refinancing in 2012. For comparison, Germany needs EUR 325 bn or 19% of estimated GDP in 2012.



Sources: DB Research estimates

How much could China contribute?

Many news reports paint a picture of China as being awash with cash due to its large foreign exchange reserves. However, these reserves are for the most part invested in long-term sovereign debt instruments, with around 60-65% in USD instruments, 20-25% in EUR assets and the remainder split between other currencies. Presumably only a very small fraction is held in highly liquid short-term paper. Theoretically, even longer-dated instruments could be liquidated; but given the large amounts necessary in the case of the GIIPS countries, this would send ripple effects through the UST market (except that Beijing decided to sell German Bunds and other core-EMU government bonds instead). Therefore, a more realistic scenario would be a slight acceleration of FX reserve diversification by investing an increasing share of additional or new reserves in euro assets. Let us assume that total reserve accumulation in 2012 amounts to USD 650 bn (EUR 500 bn), which is the DB forecast. Even if the euro share were to rise to 30-35% this would only mean USD 195-228 bn (EUR 150-175 bn) in financing available from China – or 20-24% of the GIIPS countries' total refinancing requirements.

Hoping for the Chinese white knight

The analysis above shows that even if China were willing to buy more troubled eurozone countries' sovereign debt this would not be sufficient to solve the GIIPS debt crisis. Moreover, we doubt that China is willing to take on substantial additional risks. Even China Investment Corporation (CIC), China's sovereign wealth fund with a global portfolio of USD 135 bn, would be hesitant to load on GIIPS bonds as its "underlying investment objective is to seek long-term, sustainable, and high financial returns […] within acceptable risk tolerance."*** On top of that, Chinese public opinion towards increased investment is unlikely to be supportive as the general perception is that the troubled eurozone member countries have lived beyond their means and are now turning to the savings of a country that is still confronted with domestic development needs of its own.

*Ma, Jun and Wenjie Lu (2011). Downgrading China growth. Deutsche Bank Global Markets Research, 17 August 2011.
**Refinancing requirements are calculated as the estimated government budget deficit in 2012 plus outstanding T-bills plus government bond & loan redemptions in 2012.
***CIC, Annual Report 2010, p. 27.

Deutsche Securities Limited, Tokyo Branch. In Australia, retail clients should obtain a copy of a Product Disclosure Statement (PDS) relating to any financial product referred to in this report and consider the PDS before making any decision about whether to acquire the product.