Where does China stand in the Euro bond debate?

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Executive Summary

China, along with many other external observers, has stressed the need for the Eurozone to propose, and fully commit to, a clear solution for the debt crisis and recapitalisation of vulnerable banks. Without this, there will be considerable reluctance on the part of China – or, indeed, any foreign investors - to significantly participate in fundraising exercises for bailout countries or for those states whose bond markets have come under pressure.

To be successful in encouraging foreign investor participation, any vehicles used for fundraising must meet external criteria such as:

- The provision of a transparent and readily understood set of guarantees: simplicity is a great benefit and even complexity regarding the planned 2013-14 changeover from the European Financial Stability Facility (EFSF) to a permanent European Stabilisation Mechanism (ESM) may sow doubts about long-term valuations of investments and raise the risk premium;
- Choice of a structure and duration that best meets investor preferences, which may imply seeking a wide range of advice (for example, from Asia-based financial experts) on how to best target certain investor groups;
- A feasible timetable and scale of bond issuance that will suit the most important external investors;
- Sensitivity analysis could help improve terms and conditions -- if the structure is optimised, the guarantee levels provided may be able to ease back without significantly raising the interest rate offered to investors.

If the Eurozone needs the support of international investors, then it will have to take into account their views and preferences regarding the form of investment vehicles offered. For example, this argues overwhelmingly in favour of the expanded use of the EFSF to raise funds for troubled debt markets - not only because of the provision of strong guarantees but to enable smooth management and design of the fairly heavy stream of bond issues, avoiding fragmentation of the market and counterproductive competitive pressure in issuance.

Consideration might also be given to the maturity of bonds offered. Issuance of more short-dated bonds (maturity of three years or less) could appeal more specifically to Asian investors who have represented almost 90% of external investment in recent issues (e.g. based on the statistics for participation in the EFSF’s 5 billion euro bond issue for Portugal in mid-September). This may imply widening the number of advisory banks/services involved in assessing the structuring and distribution of bond issues and the views of target investor groups.
**Background Brief: Where does China stand on the Euro bond debate?**

**Introduction: Perceptions of the background to the crisis and the risks created by small fragmented markets**

The Eurozone has suffered severe reputational damage, firstly from the eruption of the periphery debt crisis but latterly from the continued high level of uncertainty regarding how the crisis will end. Rightly or wrongly, most foreign observers see this as a complicated internal debate within the Eurozone in which they cannot, nor do they wish, to play a role. However, external investors are willing to consider injecting funds on a normal commercial basis – that is, by assessing any issues offered to the market according to their own cash flow positions, the perceived risk profiles of the investment vehicles offered, and in comparison with the alternative investments available.

QUOTE: Speaking during the World Economic Forum in Dalian in mid-September, Zhang Xiaoqiang (vice chairman of the top economic planning agency), is reported to have said that China would be willing to buy Euro bonds from countries involved in the sovereign debt crisis “within its capacity”. This was in line with other comments he and Premier Wen Jiabao had previously made.

So far, the damage has not had detrimental effects on the German bund market but it has notably raised the premium on France’s debt (and threatened the government’s AAA credit rating) and markedly impacted on Italy and Spain - in spite of these countries not being in bailout programmes and in spite of their efforts to contain fiscal risks.

For Asian fund managers, and other potential investors, the periphery debt crisis has been especially confusing and tiresome as it has required greater information gathering and analysis for the indebted small economies, which hold little intrinsic interest. This also highlights the inefficiency of raising funds through such small markets, even in periods of robust economic progress.

During the years just before the global financial crash, the prevailing assumption was that Eurozone bond yields could, and should, converge more closely because the most important differential risks had been eliminated by currency union and the possibility of debt crises and defaults was virtually ruled out. Yet even in this optimistic period, foreign investor
participation (from outside of the European Union) in the small, periphery markets was narrow and low – there was effectively a two-tier market of “Senior” and “Junior” partners (the former including Germany and France and the latter Portugal and Greece). This is indicated by the relatively large concentration of these bonds that remained within the Eurozone banking system, creating a heavy exposure that has now exacerbated concern over the strength of the banks.

Arguably, if the small Eurozone countries had been able to raise money in a consolidated “Euro bond”, or “Junior Euro” market, this might have marginally reduced the risk premium compared with the large Eurozone bond markets. More importantly, however, it would have encouraged a wider range of investors, critically spreading risks that have instead fallen heavily on the Eurozone banks. In fact, consolidation of “Senior Euro” sovereign debt into a deeper, more liquid single market might also have reduced its risk premium versus US Treasuries.

**Today’s calls for consolidated bond markets**

 Calls for the creation of a single Eurozone sovereign debt market, in part to capture the benefits of a “large market” effect and a more diverse investor base, were already active before the debt crisis broke. However, such calls have escalated in tandem with the Eurozone debt crisis. Most proponents see this as a long-term target for the better functioning of the Eurozone sovereign debt market – to truly create a rival to that of the US - but others believe that it should also be considered in the short run as a possible way forward from the persistent debt crisis.

 While a fully unified market would almost certainly be impossible in the near term (requiring a change in the EU’s Lisbon Treaty), the EFSF has been interpreted as a precursor of a single Eurozone bond market. This fund is currently tasked with the very limited job of supporting the agreed bailouts of Greece, Ireland and Portugal but, within the terms of the present Treaty, it could act as a vehicle for a more strategic and substantial move (gradual or fast) towards a consolidated debt market for all those countries otherwise struggling to access capital markets at acceptable rates of interest.

 These suggestions typically point to either the whole Eurozone moving towards the unification of its national bond markets or the development of a segmented market with varying levels of guarantees for investors (e.g. blue bonds backed by the Eurozone and red for “top up” nations borrowing above prudential guidelines that would have only national
guarantees – or other forms of Senior versus Junior markets consolidated either as geographic groupings or as types of issues).

Certainly, the use of Eurozone-backed bond issues as a means of funding Member States in financial difficulties is already introducing a substitution effect from the most seriously malfunctioning national markets to a new market category for distressed Member States. And these new issues are readily appealing (on commercial terms) to external investors, including China.

BOX

The Eurozone bond market: Designing issues to suit investor tastes

Proponents of a unified Euro bond market typically take inspiration from the US model – as they point out, average Eurozone debt levels are not worse than that of the US economy but the whole US government bond market trades at low yields, practically the same as those of the German bond market. In fact, prudent Sweden has to pay almost the same interest costs on its debt as the US and Germany -- providing an even better example of the penalty of being a “small” market. Austria too appears to suffer in longer dated issues.

Overall, while the price of a bond (which determines the spot interest rate) reflects largely (i) the currency risk and (ii) the default risk relative to other countries, it also includes (iii) technical factors, such as size and liquidity of the market. The latter factors will affect the premium or discount in the market compared to bonds otherwise rated with exactly the same default and currency status.

In addition, there is likely to be an even greater propensity for investors to require a higher premium on “small country” debt in cases of increased default or currency uncertainty – premium increases are likely to be non-linear. In contrast, large liquid markets (primarily the US) continue to benefit simply from their size.

In addition, in comparison with the Eurozone, the US benefits from both its strong federal debt guarantee and belief in the dollar as an unchangeable single currency. The Eurozone cannot present such strong credentials, and will pay additional interest costs - in part because of its short history, but also because of the fragmented nature of its sovereign bond markets and governance: the former cannot realistically be divorced from the latter.

The most practical way forward is to expand the EFSF as a means of testing investor interest and gradually growing the “Stability bonds” (or “Junior”) market. This is no different to the
approach taken in growing any new market segment and the pricing (and need for guarantees) can gradually be adjusted according to improved information and liquidity in the market.

A comparison could be made to the successful development of the offshore renminbi market in Hong Kong since mid-2010, which has grown from virtually zero (with early issues bearing relatively high coupons) to a market now worth over 25 billion US dollars (with coupons now typically ranging between 50 and 200 basis points [bps] after initially higher premiums for early launches). In this case, the success has been in spite of this being composed of fragmented small issues from a variety of corporate and official borrowers (hence the nickname, the “dim sum” market) – helped by promotion of the “umbrella view” of the “single” renminbi offshore market.

Conclusions of the Rossi and Jackson (Chatham House) study (of which an extract is provided below) include the opinion that “the RMB bond market could develop into a market valued at over $700 billion by 2020 and in the ‘high growth’ case, this figure could be greater than $1 trillion.”

Funding costs, the investor base and structure of issues

Since the Greek debt crisis broke in early 2010, European opinion has typically been highly critical of the behaviour of financial markets and investors. There have been many vocal complaints about the soaring costs of borrowing for countries in financial distress and other highly indebted Member States – and little interest in the views of investors. Complaints have also been stirred by the gaping differential between the high interest rates that debtors might have to pay in the open market and the very low rates seen in the German bund market or, outside of the Eurozone, in the UK. Escalating interest costs of course add to financial distress and the inability of governments to reduce public sector deficits and debt, potentially forcing them into a vicious spiral into debt crisis. In this case, the appeal of a single market is clear – it is based on the expectation that this would enable all Eurozone countries to access funding at low interest rates.

However, this analysis ignores the fact that the degree of success of any bond issues and the level of interest rates fixed depend not only on the issuer but also on the appetite of potential investors and their risk assessment.
At the present time, given the heavier funding requirements of almost all of the advanced economies, net inflows of funds from foreign investors are particularly important. These will predominantly be investors from emerging markets, chiefly from Asia.

Eurozone investors will be the largest single contributor to funding Eurozone government debt – but they will also diversify bond holdings across the major global markets. On their own, Eurozone savings will thus be insufficient to meet all the funding requirements of the bloc itself.

Investors from other advanced countries will also diversify their holdings and will be buyers of Eurozone debt but the scope to increase net holdings is presently very limited given the substantial funding needs of most of these countries. Indeed, simultaneously high debt across the developed countries is creating competition for funds.

**Figure: Global current account imbalances show savings surplus countries are chiefly China, Japan, the GCC and Russia (source IMF).**

The net balance of capital to meet the Eurozone’s funding needs will have to come from the savings surplus countries – primarily from Asia and the oil producing economies.

Of these, China has the largest savings surplus, **typically generating around 200-300 billion US dollars per annum in new investments**, which adds to a massive existing stock of foreign exchange reserves held abroad. These reserves were reported as reaching 3.2 trillion US
dollars by the end of September 2011. Japan and the rest of surplus Asia form the second largest bloc of net foreign investors.

The opinions of Asia, and especially China, are therefore critical and might dictate the success or failure of efforts to meet the funding needs of governments throughout the developed world.

There has already been a process of “courting” of Chinese investment during various visits to Greece, Portugal, Spain and recently Italy but the unspoken message that appears to have emerged is that China does not want bilateral, or indeed any special, involvements in European debt markets although it has participated, and will continue to participate, in each bond issue on its own merit. It has notably added its voice to calls for the Eurozone to commit to clear solutions for its debt crisis.

QUOTE: "If it has a risk profile that fits into our allocation, we'll buy some," said Gao Xiqing, president of the sovereign-wealth fund, the Chinese Investment Corporation (CIC). "But don't expect us to buy more than our risk appetite would take."

China’s present position as an international investor

Looking firstly at the current state of play, it is possible to infer some facts about China’s current financial position and its international investment policies and preferences. For example:

- The build up of the central bank’s foreign exchange reserves has implied a parallel build up of government bond holdings, chiefly US Treasuries but also European government bonds.

- As the scale has increased, funds have started being shifted into sovereign wealth funds, largely to expedite the diversification of the portfolios managed – for example into share holdings that would not be suitable under the mandate of a central bank foreign exchange reserves portfolio.

- While expressing unease about the impact of a weaker dollar on US investments, the central bank has had little choice but to continue holding most of its funds in US bonds – most estimates suggest that as much as 2 trillion US dollars of China’s
reserves are held in US dollar investments, with over 1 trillion US dollars held in Treasuries (confirmed by official US data).

- In contrast, holdings in the euro bond markets may be less than 1 trillion US dollars, in part because of the problem of how to place such a large investment within a set of fragmented sovereign debt markets, the largest of which (Italy, Germany, France) are only valued at around 2-2.5 trillion US dollars each.

In principle, China’s holdings in the Eurozone debt market could increase markedly, simply to meet a “fair weighting” compared with the US according to the importance of the dollar and euro in the international economy. Such a rebalancing might imply a one-off injection of funds into the Eurozone of as much as 200-300 billion US dollars as well as raising annual capital inflows into the Eurozone to 70-100 billion US dollars.

Conclusions: would China be interested in Eurobonds?

The key messages to Eurozone policymakers from external (non-European) investors - chiefly the savings surplus countries of China, Japan and Singapore - are clear:

- Get on with the task of setting out and practically developing an appropriate structure of debt markets and instruments to meet the fundraising required to resolve the debt crisis.

- Do not expend effort trying to persuade external (non-European) investors to buy bonds in markets or forms that do not match either their preferences (structure, rating, maturity) or the amount of time and analytical resources they will be prepared to commit.

- Tailor specific fundraising proposals accordingly to investors’ preferences: investigate and offer bond issues structured in ways that will most readily appeal to the target investor base on a normal business basis.

- Decisions to support an issue or not are likely to be made on normal commercial grounds - attractive issues will be taken up.

China will continue to see growth in its wealth managed abroad. These funds will be keen to seek an appropriate balance of international investments, yet their present positions are
probably underweight in euro assets. This points to the opportunity to raise participation
and inflows of capital to the Eurozone but it also highlights previous failure to substantially
deepen the involvement of investors from across Asia and other emerging markets.

To attract significant funding from the world’s largest investors, a market must be
commensurately large and liquid (across a range of maturities) to allow ease of entry and
exit. Central banks also require appropriate ratings.

In summary, there is every reason to believe that a consolidated Eurozone bond market with
strong guarantees (particularly for smaller countries’ sovereign debt) would be better suited
to external investors and would appeal to Asian, including Chinese, central banks and wealth
funds. This is an immediate concern for the Eurozone. But, in view of the likely future flow
and demand for capital, tapping this investor base will remain important for the Eurozone in
the future and may be fostered by consideration of China-oriented issues.
Extract from “Hong Kong’s Role in Building the Offshore RMB Market”, Vanessa Rossi and William Jackson, Chatham House, June 2011

Through 2010, the development of the offshore RMB bond market accelerated markedly, albeit from a low starting point. By August, RMB bond issues in Hong Kong had reached close to RMB 40 billion. And during the second half of 2010, issuances skyrocketed (totalling over RMB 35 billion), increasing the market size by almost 100%.1 In absolute terms, these figures are all low2 but they indicate the rapidly rising interest in the sector. Corporate issues have all been for relatively small amounts and short-dated, with maturities around 2-3 years (typical for Asia) and coupon rates of approximately 3%.

Among the most notable bond issuances (both corporate and public sector) in Hong Kong have been:

- China’s Ministry of Finance issued three different maturities of bonds in autumn 2009 (RMB 6 billion at maturities of 2, 3 and 5 years) – this approximates to sovereign issuance.

- The July 2010 issuance of RMB 1.4 billion with a maturity of 2 years by Hopewell Highway infrastructure was the first corporate RMB bond to be issued that was made available to international investors.

- McDonalds’s issuance of RMB 200 million with a maturity of 3 years, launched in August 2010, marked the first by a foreign multi-national company.

- The January 2011 issue for the World Bank, its first RMB denominated bond, worth RMB 500 million with a maturity of 2 years and a coupon of just 0.95%, in line with yields on China’s sovereign debt on US dollar issues.

Sovereign yield curves versus bank borrowing rates (lhs) and versus yields on RMB bonds issued in Hong Kong (rhs)

Source: Asian Bonds Online, Goldman Sachs (2010a), IMF

1 By the end of 2010, Bank of China (Hong Kong) launched the first offshore RMB bond index to track the development of the market.

2 Resulting in these issues being nicknamed ‘dim sum’ bonds.