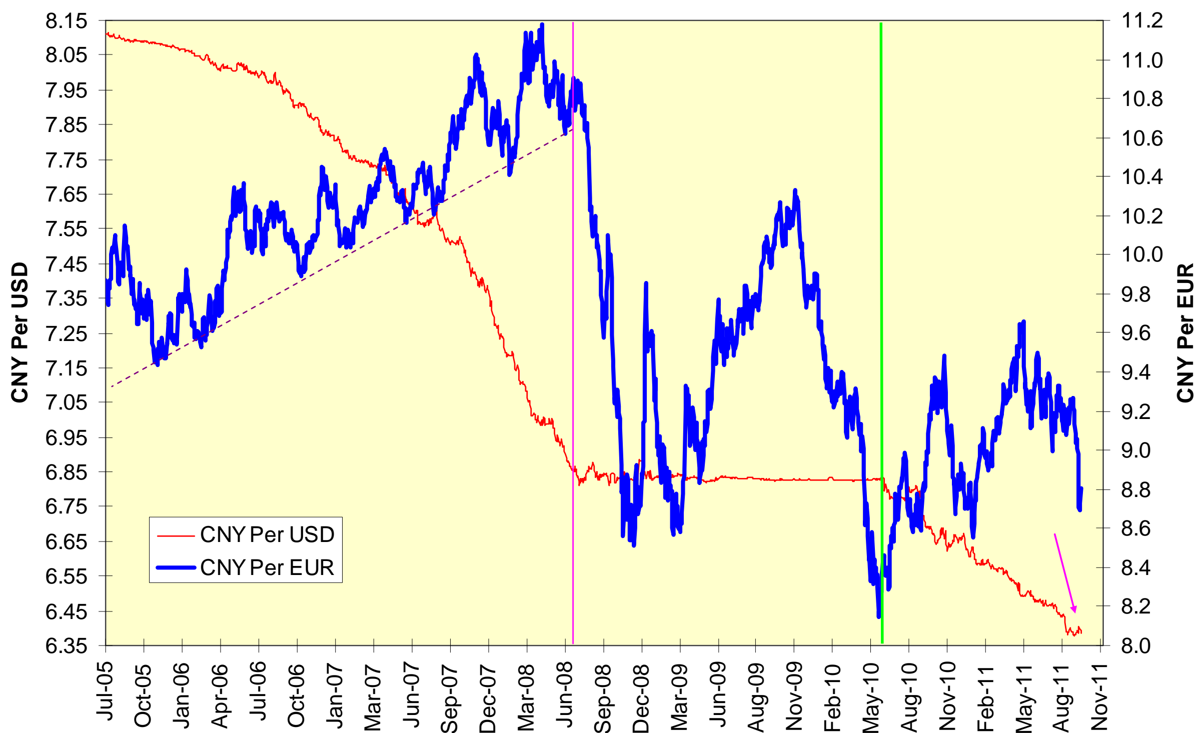
Chinese Buying Of Euro Debt Makes Sense

White House reporters during the Clinton years got in the habit of listening for "the Clinton clause," that carefully constructed nuance laid in advance against future events. I have trained myself to watch for the Chinese quid pro quo when it comes to any and all actions involving yuan exchange rates and shifts in their capital flows. This allowed me to identify their re-pegging of the yuan in July 2008 over the very same weekend Hank Paulson effectively nationalized Fannie Mae and Freddie Mac and to later identify the *pas de deux* between yuan revaluation and American quantitative easing.

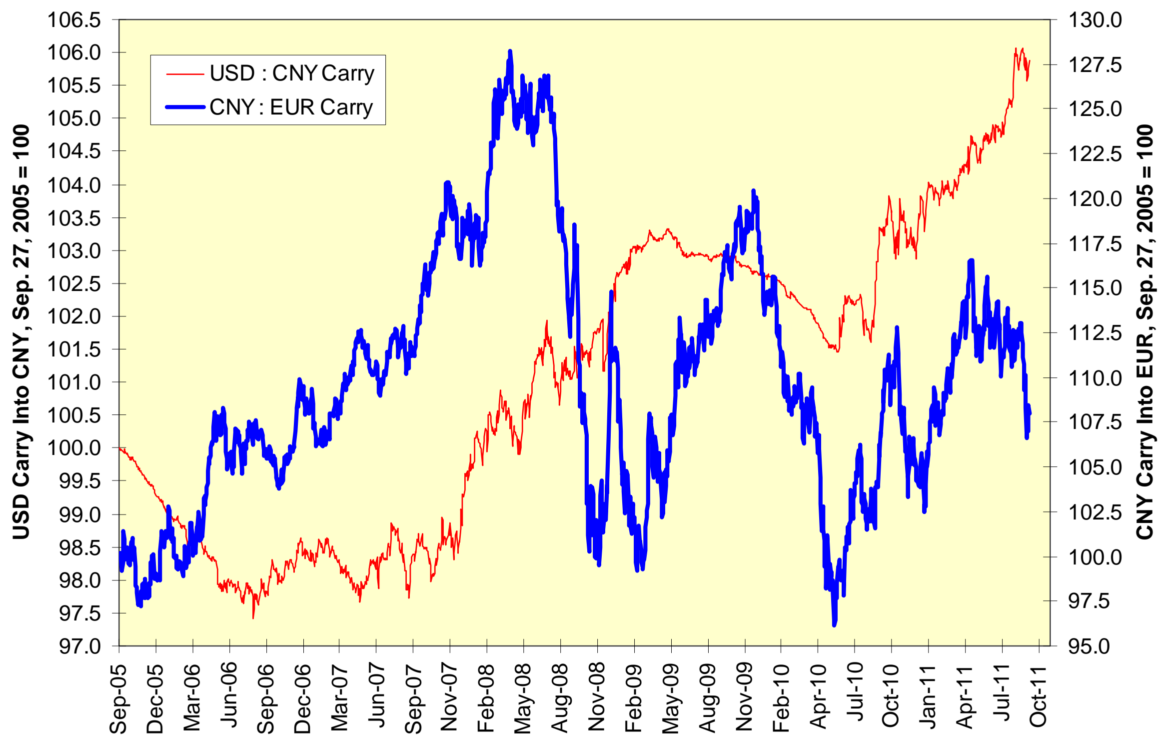
The same combination of means, opportunity and motive applies today when it comes to the never-ending European sovereign debt mess; I really hate calling anything and everything a crisis, and since this is a mess I shall call it a mess. China has the means to buy a few bonds here and there; their reported reserves at the end of June were $3.197 trillion, more than 30% of the world's total. Their motive is simple, too: All of us have been conditioned to avoid something called "another 2008," a term I interpret as representing [stuff] happening in ways you had been unable to imagine previously. A sovereign default in Europe or the implosion of a European commercial bank certainly qualifies as an antecedent for "another 2008."

Two Rates Over Three Periods

The yuan's exchange rate against the dollar has three neat periods since revaluation began in July 2005; two periods of managed movement higher and the July 2008-June 2010 re-pegging. The yuan's rate against the euro has been a far messier affair involving broken trendlines, a few broken hearts and the current de facto strengthening against a falling euro. Please note how the yuan's appreciation against the USD has stopped over the past month; I have marked this with an arrow.



This combination of exchange rate movements suggests China shifted its purchases away from the euro and back toward the dollar in recent weeks. If we rearrange the data to show the excess carry returns from borrowing the USD and lending the CNY and from borrowing the CNY and lending the EUR, we see very divergent patterns. As trading and investing are supposed to involve buying low and selling high, a trick often repeated in reverse, we should note euro-denominated assets are very cheap now for a yuan-domiciled buyer, especially one willing to shift from dollars into euros.



Of course, China did not get to its present status by running a charity; they are unlikely to shift assets into euros so long as the present circus is in town. They should and no doubt will demand currency preservation as a quid pro quo. Collateral is more difficult; what are they going to do, move the Parthenon to the Shanghai riverfront or to Macau?

Currency preservation will involve a pledge not to duplicate the American policy of printing money just to see what happens; it will involve tighter credit, higher interest rates, fiscal retrenchment and all of those other things the Eurozone has been avoiding. But the Scots have a saying for this: He who pays the piper picks the tune. The Eurozone can have Chinese money or it can have its present policies, but it cannot have both.