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China aids eurozone QE drive with sales of German bonds

Claire Jones in Frankfurt and Gabriel Wildau in Shanghai

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Eurozone central bankers, struggling to boost the currency area's flagging recovery, have received help from Beijing in delivering their €1.1tn quantitative easing plan thanks to sales of German government debt by the People's Bank of China.

The PBoC's reserve management wing, the State Administration of Foreign Exchange, has been selling some of its German government bonds since the ECB began buying them in March, say two sources close to central banks in China and Europe.

Safe does not deal directly with eurozone central banks, which purchase bonds from investors via banks' bond trading desks. But its sales of bonds are making life easier in the dealing rooms of Europe's monetary powers, where traders have been handed the difficult task of finding €60bn of mostly government debt to buy each month as part of the QE package.

Concerns over the whether the Bundesbank, Germany's central bank, could find enough German bonds to buy have long surrounded the €1.1tn programme. The Bundesbank must purchase around €10bn of bonds a month as part of QE — a potentially problematic amount due to low levels of debt issuance by the German state, although ECB officials have repeatedly downplayed these concerns.

The Bundesbank has scoured the world for likely sellers, according to one person familiar with the matter, including Safe. Under pressure to make a return on its reserves portfolio, Safe has agreed to take advantage of the high prices on offer for the low-yielding German bonds.

"Chinese sales of German Bunds would certainly facilitate the ECB's quantitative easing operations, so this is an instance where the interests of the ECB and PBoC are congruent," said Eswar Prasad, an economist at Cornell University and former head of the China division at the International Monetary Fund.

Sales by Safe, thought to hold hundreds of billions of euros-worth of European government debt, would also help the ECB should an emerging market slowdown threaten the single-currency area's recovery and force a more aggressive package of monetary easing.

Officials in Frankfurt are expected to revamp QE in December in response to the slowdown, pursuing options that include extending their deadline for bond purchases past the current limit of September 2016 or upping their monthly count for bond buying from the current level of €60bn.

While the price of German debt could rise again if the ECB ramps up QE, any gains to Safe could be wiped out by a weakening of the euro. That would raise the heat on Safe, which records its reserves stockpile in US dollars. The single currency has dropped 13 per cent against the dollar over the past 12 months and is likely to fall further if the ECB loosens its monetary stance on December 3 and US Federal Reserve chair Janet Yellen honours her expectation to hike rates before the turn of the year.

China's reserves have shrunk from $4tn in June 2014 to $3.5tn at the end of September, as China's slowing economy and the renminbi's depreciation trigger a wave of capital outflows.

The PBoC made a surprise move on August 11 to let the renminbi weaken. Offloading government bonds — a highly liquid asset that is easy to trade — can also help stabilise currency depreciations, with the selling of foreign currency-denominated assets counterbalancing any pressure on the renminbi.

In recent months the PBoC is known to have drawn down its foreign-exchange reserves to support the renminbi exchange rate. Analysts say those interventions primarily involve selling US Treasuries.

The composition of China's forex reserves is secret. Tao Wang, China economist at UBS, estimates that China holds $1.4tn in US Treasury securities plus $800bn — or €729bn — in those of other governments, mostly in Europe, the UK and Japan. The rest is mostly agency and corporate debt, plus some US equities.

While some of the euro's founders hoped the single currency would eventually challenge the dollar's supremacy as the world's major reserve currency, that appears less of a priority for the ECB at present. Mario Draghi, ECB president, acknowledged in August 2014 that central banks were reducing their holdings of the single currency, which he suggested was because his central bank was set to stay in easing mode for a lot longer than the Federal Reserve.

The ECB said: "We provide weekly updates of bond purchase volumes but do not comment on individual transactions. We have not yet seen any scarcity of bonds to buy." The Bundesbank declined to comment.

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