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China’s Treasury Holdings Make U.S. Woes Its Own

By DAVID BARBOZA

SHANGHAI — However grim Washington’s debt and deficit negotiations may seem to Americans, the impasse is nearly as disturbing for China.

As the United States’ biggest foreign creditor — holding an estimated $1.5 trillion in American government debt — China has been a vocal critic of what it considers Washington’s politicized profligacy.

“We hope that the U.S. government adopts responsible policies and measures to guarantee the interests of investors,” Hong Lei, a foreign ministry spokesman, said at a news conference late last week.

Beijing might prefer to respond by starting to dump some of its American debt. But in this financial version of the cold war, analysts say, both sides fear mutually assured destruction.

One reason the United States would want to avoid defaulting on its debt is that such a move could alienate China, which is a steady purchaser of Treasury bonds. Beijing, meanwhile, already has too much invested in American debt to do much more but continue to buy, hold and grumble.

It is the ultimate “too big to fail” global relationship, said Andy Rothman, an analyst in Shanghai for the investment bank CLSA.

If Beijing even hinted that it might try to sell part of its American debt, “other countries might sell their dollar assets,” Mr. Rothman said, noting that this would drive down the value of

China's holdings. "It would be financial suicide for China."

China got into this situation, experts say, by indulging its own economic interests. To bolster what has become the world's largest export economy, China has focused on policies that encourage domestic savings and hold down the value of its currency. The result: huge trade and current-account surpluses. China has accumulated more than $3 trillion in foreign currency reserves, far more than any other nation.

Most of those reserves are held in dollars, and recycled back to the United States through investments in Treasury bonds and other dollar-denominated securities — even stocks. And while some of China's foreign exchange reserves are plowed into European and Japanese debt, those bond markets are not big or liquid enough to absorb the bulk of China's ever-larger foreign holdings.

Beijing has tried to diversify its foreign exchange portfolio by creating a sovereign wealth fund that can invest some of the reserves overseas. The government has also encouraged Chinese companies to expand overseas and to acquire mines and natural resources to fuel China's hungry economy. But because China has too much foreign money for any other outlet to absorb, the vast majority of its fast-growing reserves continue to be destined for the United States bond market.

"China has no choice but to keep buying," said Zhang Ming, an expert at the Chinese Academy of Social Sciences, a Beijing research group. "After all, U.S. Treasury bonds are still the largest and most liquid investment product in the world."

All of which has helped enable America's own fiscally dubious habits.

The United States' huge deficits — not only in government spending, but in trade and savings as well — have weakened its economy and strangled consumption. Many economists say that would poison the long-term prospects for the dollar, if it were not still the world's reserve currency and most reliable safe haven.

Helping maintain that role for the dollar are the staggering debt problems that Europe and Japan are struggling with. With global investors like China having few good options besides United States Treasuries, Washington, despite its current debt-ceiling debacle, can continue to hold down interest rates and wallow in cheap borrowing.

Beijing in recent years has frequently fretted aloud about Washington's monetary policies. In 2009, shortly after the global financial crisis broke out, China's prime minister, Wen Jiabao, said his country was "worried" about the safety of its huge cache of United States Treasury holdings. Last year Chinese policy advisers criticized the Federal Reserve for undermining the value of holdings by "printing too much money" with its so-called quantitative easing policies.

But even now, despite Beijing's scolding about the debt impasse in Washington, China's options may be limited.

"There's really nothing different they can do," said Eswar S. Prasad, a Cornell economics professor and former head of the China division at the International Monetary Fund. "Even if China felt the United States was going off a cliff, there's no other place for them to put their money."

Over the long run, many economists say the structural imbalances on both sides of the Chinese-American debt symbiosis could be disastrous. Already, for example, many say that those dynamics helped create the global financial crisis by artificially creating the low interest rates that let housing prices reach bubble-bursting levels.

Now, the United States and China are trying in their different ways to adjust. American policy makers are urging more savings and less consumption. Chinese officials take the opposite tack, promising to encourage more consumption and less saving.

But neither country has made significant headway on these strategies during the last two years. Both sides see these fixes as too costly and detrimental to nearer-term economic goals. America is focused on reviving its economy, while China is intent on cooling its down. And in both countries, achieving the goals involves changing public behavior, which is never easy.

Many economists say China could curb its dependence on dollar-pegged assets by letting the value of its currency rise faster against other world currencies. That would also make its imports less expensive for domestic consumers. But it would also make China's exports more expensive for global customers, which could hurt Chinese factories and lead to widespread layoffs.

For all that, if China worries about holding too many dollar-denominated assets, which could depreciate over time as the value of its own currency rises, why does it not quietly sell some of them — or at least stop buying more?

Recent United States government surveys have suggested that China began doing just that, beginning to slow its purchases of American debt earlier this year. But analysts warn that those official figures may not be accounting for purchases made through third-party countries on China's behalf. An intermediary buying American bonds in London at the behest of the Bank of China would not show up in Washington's tallies.

Many economists, in fact, say they believe China may have actually stepped up its buying of American debt. The evidence is that its trade and current-account surpluses almost certainly mean that it has continued to accumulate huge holdings of dollars.

How might the Beijing-Washington debt standoff be resolved? Mainly, the Americans hope China will ramp up its domestic consumption and perhaps make even more direct investments in the United States. The Chinese, meantime, hope the United States will deal with its huge debt problems and maintain the value of the dollar — and with it the value of China's dollar-based holdings.

For all the stresses in both directions, the fiscal cold war means "China is increasingly integrated with the future of the U.S.," said Mr. Rothman, the Shanghai analyst. "But that could be a good thing, for both sides."

Xu Yan contributed research.