SECTION 2: THE IMPLICATIONS AND REPERCUSSIONS OF CHINA'S HOLDINGS OF U.S. DEBT

Introduction

Over the past decade, the U.S. government has been incurring a rapidly rising national debt as the gap between tax collections and spending has widened. The 46 percent increase in government debt held by the public during this period was financed by the sale through auction of ever-larger amounts of Treasury securities.* At the same time, purchases of Treasury securities by foreign central banks have increased while purchases by individuals have decreased.† Of the $7.5 trillion in publicly held U.S. Treasury securities at the end of March 2010, $3.9 trillion, or 52 percent, was held by foreigners.[91] The Chinese government, through its central bank, has become the single largest foreign purchaser of U.S. government debt to finance the federal government's budget deficit. In July 2010, for example, China and Hong Kong together held $982 billion of the outstanding, officially registered U.S. Treasury securities. Thus, China accounted for a quarter of all the publicly held Treasuries owned by foreigners and about 12 percent of the overall publicly held Treasury debt.[92]

China's total purchase of U.S. government debt, including large-scale purchases of the bonds of U.S. government-owned Fannie Mae and Freddie Mac and unregistered purchases of Treasuries through Caribbean tax havens and through the London currency market, are estimated to be far larger, perhaps double the amount of officially registered purchases.[93]

The growing U.S. debt held by foreign governments, particularly that of China, has raised "the fear that if foreigners suddenly decided to stop holding U.S. Treasury securities or decided to diversify their holdings, the dollar could plummet in value and interest rates would rise," as noted in a March 2010 report by the Congressional Research Service. Others are concerned that "China's accumulation of hard currency assets will allow it to undertake activities in the foreign affairs and military realms that are not in the U.S. interest."[94] Typical of the concern that the United States is

* Debt held by the public increased from $5.7 trillion in January 2000 to $8.4 trillion in August 2010. Source: U.S. Department of the Treasury, *Monthly Statement of the Public Debt of the United States* (Washington, DC: U.S. Government Printing Office, August 31, 2010). *http://www.treasurydirect.gov/govt/reports/pd/mspd/2010/opds072010.pdf*.

† Debt held by the public consists of marketable U.S. Treasury bonds, bills, notes, and savings bonds sold to individuals, corporations, state and local governments, and foreign governments. These securities can be resold on the secondary market. By contrast, debt held as "intragovernmental holdings" does not consist of marketable bonds. Such debt is owed by one agency to another, principally to the Social Security and Medicare trust funds. The debt calculations within this Annual Report refer to the debt held by the public in the form of marketable U.S. Treasury securities, as defined by the U.S. Department of the Treasury.

increasingly beholden to China is this warning in the *Wall Street Journal*: "At some point, the United States may have to bend its policies before either an implicit or explicit Chinese threat to stop the merry-go-round. Just this weekend, for example, the United States angered China by agreeing to sell Taiwan $6.4 billion in arms. At some point, will the United States face economic servitude to China that would make such a policy decision impossible?" [95]

While there has been considerable press coverage and public debate raising this concern, there has been little analysis of the likelihood of such a move. In fact, China is unlikely to choose to sell its dollar holdings. There are no adequate substitutes in the international currency markets for the dollar, which is the world's dominant reserve currency. If China were to decide to sell its Treasury securities, China would lose billions of dollars and also have to abandon the very system that supports its export-led economy.

The Relationship between China's Holdings of U.S. Debt and Its Influence

There is anecdotal evidence that Chinese officials perceive that China's self-described role as "America's banker" has granted the Chinese government at least some leverage over Washington's policy decisions. Some American officials may also have that perception. Witnesses at a February 25, 2010, hearing before the Commission warned that U.S. government leaders might falsely assume that they are in a dramatically weakened position because of U.S. debt held by China. U.S. government officials might be hesitant to criticize China's economic policies, human rights transgressions, or aggressive acts toward Taiwan, for example, in the fear that the Chinese government may stop buying U.S. debt instruments.

The danger is that misperceptions on both sides can lead to miscalculations by officials. In early 2009, as the administration sent its first cabinet-level delegations to China, the United States sought to downplay long-standing contentious issues and instead to concentrate on areas of mutual interest, such as the economy. "You had Secretary of State (Hillary) Clinton and then Secretary of the Treasury (Timothy) Geithner almost pleading for China to buy U.S. bonds," said Commission witness and political scientist Daniel W. Drezner of Tufts University. "So I think that might have sent an errant signal to the Chinese," he said.[96]

While in China in February 2009, Secretary Clinton did not raise the human rights issue but did praise the Chinese government for its willingness to continue to hold U.S. bonds. U.S. Treasury Secretary Timothy Geithner also sought to reassure Chinese audiences during his first trip to China in May 2009 that U.S. assets held by China "are very safe."

History has demonstrated that lending nations have sought to use financial leverage to achieve foreign policy goals. After Britain and France occupied the Suez Canal in 1956, the Eisenhower Administration prevailed on Britain to give up the canal to United Nations (UN) supervision in part by threatening to withhold further purchases of British debt. Facing the collapse of the pound sterling, Britain capitulated.[97] "The lesson of Suez for the United States today is clear: political might is often linked to financial might, and a debtor's capacity to project military power hinges on the support of its creditors," wrote then Council on Foreign Relations economist Brad Setser in *Sovereign Wealth and Sovereign Power: the Strategic Consequences of American Indebtedness*.[98] Representative Frank R. Wolf, testifying before the Commission, also noted the parallels between Great Britain in 1956 and the United States in 2010. "Only this time, the U.S. is in a much more precarious position," Representative Wolf said. "Rather than operating from a place of financial strength, we are increasingly at the mercy of foreign lenders."[99] Even America's military strength may be at risk if creditors cut lending, some believe. China's financing of the U.S. government "facilitates the U.S. role as the world's hegemonic leader," according to Clyde Prestowitz, president of the Economic Strategy Institute in Washington and a witness at the Commission's February 25 hearing. Said Mr. Prestowitz:

> *No way would we be able to afford to maintain troops in Afghanistan and Iraq and, indeed, ironically, patrol the Western Pacific with the Seventh Fleet around China if it weren't for Chinese money. We wouldn't be able to rebuild New Orleans, or do lots of the other things that we do, without Chinese money. So, in many respects, it facilitates us, but, of course, it also has inevitably the burden of obligation.*[100]

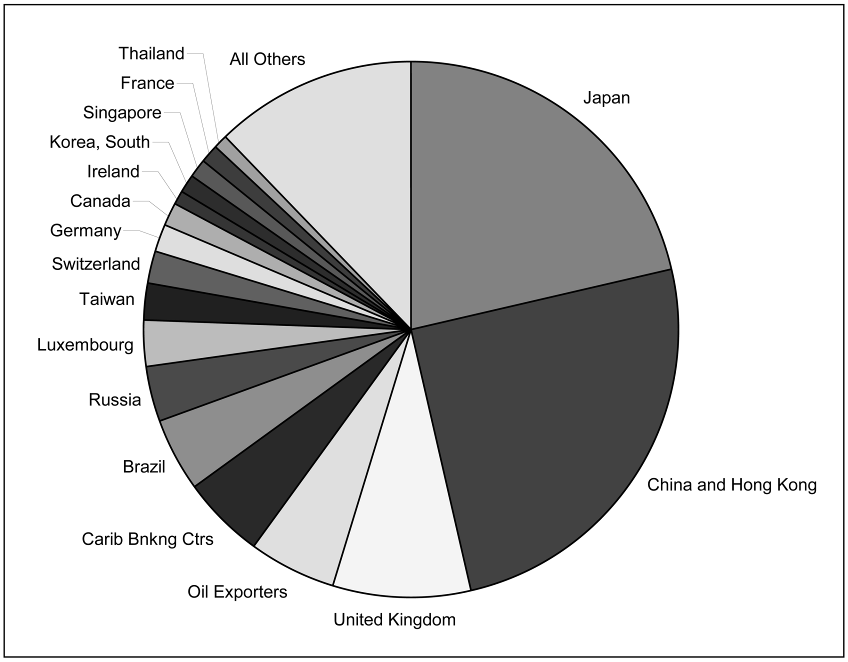
Nevertheless, there is no economic justification for the view that the United States is beholden to China for its lending, according to testimony at the Commission's February 25 hearing. As described below, China's purchases of U.S. Treasuries are part of China's overall industrial policy and its export-based economic strategy. Far from aiding the United States, the Chinese policy, with its emphasis on running large trade surpluses, actually places the U.S. economy at a disadvantage. China is simply acting in its own interest when it seeks a return on its export-driven dollar earnings by purchasing U.S. Treasuries. "China has two choices: buy U.S. bonds or build a really big mattress," said Derek Scissors, an economist at the Heritage Foundation, who testified at the February 25 hearing. "Those are the only two options for their money (dollars)."[101]

There are other reasons for China to continue to buy U.S. Treasuries. For example, China's dollar holdings are so large that only the U.S. dollar bond market has the size and liquidity to absorb such a large amount of currency. The People's Bank of China holds in dollar-denominated debt securities an estimated 70 percent of its self-reported $2.65 trillion in foreign exchange reserves, or $1.85 trillion.[102] Add dollar investments by China's sovereign wealth fund and its state-owned companies and other government branches, and the total of dollar investments by the state sector exceeds $3 trillion, according to estimates by Dr. Drezner.

Any substantial sale of so much dollar-denominated debt would reduce, at least temporarily, the dollar's value on international markets. As the dollar's value fell, so too would the value of dollar-denominated securities held by the Chinese government. "A decision by China to switch away from the dollar would lead to a dramatic fall in the value of its sizeable (dollar) portfolio of external reserves," Dr. Drezner told the Commission. He calculated that a

10 percent drop in the value of China's dollar holdings would result in a loss of about $150 billion, roughly equal to 3 percent of China's gross domestic product (GDP).[103]

Figure 1: Major Foreign Holders of U.S. Treasury Securities (December 2009) Total: $2.7 Trillion



Source: U.S. Department of the Treasury, *Treasury International Capital System* (Washington, DC: 2009).

China's Rationale for Buying U.S. Government Debt

The People's Republic of China, along with Hong Kong, has officially reported about $1 trillion in holdings of U.S. Treasury securities, making China the U.S. government's largest creditor nation. But that does not reflect the entirety of Chinese government investment in U.S. government bonds. Some Chinese purchases are made through brokers or other third parties and are therefore not attributed to China in official U.S. statistics. The U.S. Treasury Department keeps track of the location of Treasury bond sales but not necessarily the ultimate owner.

The U.S. Treasury holdings are only a portion of the total Chinese investment in U.S. securities, notes Simon Johnson, an economist at the Massachusetts Institute of Technology and former chief economist at the International Monetary Fund (IMF).[104] The official accounting does not include U.S. Treasury securities purchased by the Chinese government through dealers in London, where the State Administration of Foreign Exchange, a subsidiary of the People's Bank of China, maintains an office. Nor are China's purchases registered officially when they are made through other international intermediaries in the Cayman Islands or the British Virgin Islands or similar tax havens. Rather, they appear as purchases by the particular tax haven. The official U.S. Treasury figures also do not include China's holdings of Fannie Mae and Freddie Mac bonds, despite the fact that both companies are now U.S. government owned.*

China's Treasury Purchases Are Strategic

Most of the purchases of U.S. dollar-denominated debt securities were funded from China's large current account surpluses with the United States over the past decade. This surplus is the result of China's dollar earnings from its exports and dollars sent to China to invest in new plant and equipment. This surplus grew nearly sixfold over the decade, rising from a total cumulative $351 billion in 1999 to $2 trillion in 2009. By Chinese law, these dollars are to be exchanged at China's state-owned banks for local currency. The dollars are then used to buy U.S. dollar-denominated debt, principally U.S. Treasuries.

China's willingness to reinvest its export earnings primarily in low-interest-bearing U.S. Treasury securities has helped create the misperception that China intends to loan money to the United States as a favor or to gain influence in Washington. In fact, the government of China purchases U.S. Treasuries as a safe investment vehicle for its accumulated dollars and as part of its strict capital controls designed to maintain an artificial, government-set exchange rate between the renminbi (RMB) and the dollar.

Some Chinese officials have perpetuated the notion that China is principally motivated by a desire to lend to the United States. These officials have warned Washington that continued purchases of U.S. Treasuries might be contingent upon good relations with Beijing. Gao Xiqing, president of the China Investment Corporation, China's $300 billion sovereign wealth fund, noted in an interview with American journalist James Fallows that:

> *The simple truth today is that your economy is built on the global economy. And it's built on the support, the gratuitous support, of a lot of countries. So why don't you come over and . . . I won't say kowtow, but at least, be nice to the countries that lend you money.*[105]

Chinese Premier Wen Jiabao and other top officials have taken a slightly different tack, lecturing Washington on its profligacy. The implication is that the government of China will stop investing in dollar-denominated debt if the United States allows inflation to reduce the value of China's investments. At a press conference at Beijing's Great Hall of the People, Premier Wen complained:

> *We have lent a huge amount of money to the United States. I am a little bit worried. I request the U.S. to maintain its good credit, to honor its promises, and to guarantee the safety of China's assets.*[106]

* Both government-chartered corporations are now owned by the federal government but were publicly owned and traded when the Chinese government purchased their debt prior to September 2008. U.S. Treasury figures do not reflect China's purchases of U.S. corporate bonds and U.S. equities.

"The Chinese have taken a very aggressive stance that the United States has become more dependent on China," Eswar Prasad, a Cornell University economist and former head of the China desk at the International Monetary Fund told the Commission at its February 25 hearing. "This narrative, in my view, has been abetted by the U.S. Administration, which has seemed almost to be going to the Chinese and arguing that the Chinese should please continue financing our deficit. I think the U.S. has more power than it has been willing to use." [107]

In one widely quoted instance, during her first trip to China, Secretary Clinton told a Chinese television audience that "the Chinese know that, in order to start exporting again to its biggest market, namely the United States, the United States has to take some very drastic measures with this stimulus package, which means we have to incur more debt. . . . It would not be in China's interest if we were unable to get our economy moving again. So, by continuing to support the American Treasury instruments, the Chinese are recognizing our interconnection." [108]

Secretary Clinton did make the important point that was repeated by several witnesses during the February 25 hearing: China's purchase of U.S. government bonds is actually central to China's overall economic strategy. China's investment and export-led growth strategy depends on an undervalued RMB, which makes Chinese exports cheaper and attracts foreign investment. Former Federal Reserve Board Chairman Paul Volcker, for example, notes that China is simply acting in its own interest as it invests in U.S. Treasuries and not out of any warm feelings toward Washington:

> *They hold all these dollars because they (the People's Bank of China) chose to buy the dollars, and they didn't want to sell the dollars because they didn't want to appreciate their currency. It was a very simple calculation on their part, so they shouldn't come around blaming it all on us.* [109]

In sum, witnesses and other experts generally agree that China purchases U.S. Treasuries to serve China's own interests.

The Implications of a Chinese Sale of U.S. Bonds

A decision by China to dump the dollar as its main vehicle for foreign reserves theoretically would carry consequences for the United States, particularly if other countries holding dollars followed China's lead. The United States benefits in several ways from the dollar's status as the world's preferred reserve currency. Because the U.S. government can borrow in dollars, it does not face the risk that fluctuations in currency values could cause the government to owe more principal than it borrowed. Because foreign governments generally hold their dollar reserves in Treasury securities, this lowers the interest rate that the U.S. government otherwise would pay to lenders. The McKinsey Global Institute calculates the benefit of such recent foreign lending as a savings of $90 billion annually.[110] The U.S. government also benefits from the use of U.S. currency as a globally accepted medium of exchange, because the government can print the money and spend it without having to pay interest, a practice known as "seigniorage." [111] The vast majority of outstanding U.S. currency, $666 billion, was printed in $100 bills and is now mostly held by individuals in other countries.[112] Those holding this currency are essentially making an interest-free loan to the U.S. government.

China's purchases of U.S. Treasuries serve Beijing's current economic goals of maintaining high growth by fostering exports and investment. China could not cease this form of lending without affecting the current basis for its economic growth, exports and investment into China. Suggestions by Chinese officials that the central bank might sell its current dollar-denominated bonds necessarily would imply a dramatic shift away from the export-led growth that China has depended upon throughout the past decade. A third threat, that China will move its export earnings into a different reserve currency, is not credible given the lack of an alternative.

If China were to cease using its huge yearly dollar earnings from exports to buy U.S. Treasury securities and instead hold the actual currency and forgo the interest it otherwise earns on Treasury securities, that would also be the equivalent of an interest-free loan to the United States. The Treasury Department might simply print the number of dollars held by China and use that to buy Treasuries, according to Peter Morici, former chief economist at the U.S. International Trade Commission.[113] Another reason why China is unlikely to stop buying and simply hold dollars: China depends on the interest it receives from its Treasury holdings to justify to its citizens its huge investment in U.S. assets. In addition, Europeans and Japanese would likely step in to buy U.S. Treasuries if China were to sell.

If China were to switch from Treasuries to U.S. corporate bonds, it would likely cause some temporary increase in the interest rate that the U.S. government would pay. But the increase would be offset quickly by a reduction in the U.S. corporate bond rate and, eventually, the Treasury rate as "those who sold assets to China's central bank receive money that becomes part of the larger pool that funds U.S. Treasury obligations," notes Peking University's Guanghua School of Management economist Michael Pettis.[114]

A wholesale shift to the two other reserve currencies, the euro or the yen, is not feasible, because neither currency circulates sufficiently to provide a real alternative to the dollar, which constitutes 62 percent[115] of the world's reported currency reserves.* The dominance of the dollar in international markets is more pronounced when measured by currency transactions. The dollar was used in 85 percent of international currency transactions, while the euro was involved in fewer than half as many currency swaps—39 percent.[116]

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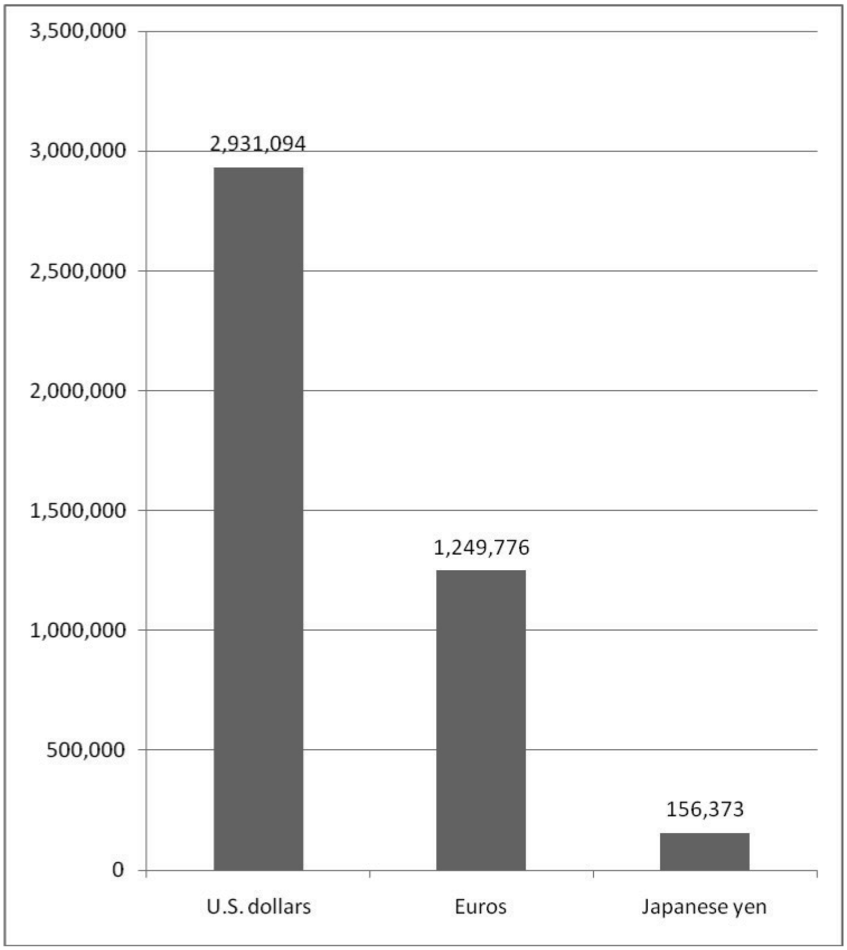
*By contrast, the euro constituted 27 percent of reported reserves and the yen just 3 percent, according to the International Monetary Fund. For a longer explanation of the dollar's role as the world's reserve currency, see U.S.-China Economic and Security Review Commission, *2009 Annual Report to Congress* (Washington, DC: U.S. Government Printing Office, 2009), chapter 1, section 1, p. 25.

Figure 2: Global Currency Composition of Official Foreign Exchange Reserves (U.S. $ millions)



Source: International Monetary Fund Statistics Department, *Currency Composition of Official Foreign Exchange Reserves Database and International Financial Statistics* (as of second quarter 2010) (Washington, DC).

Dr. Drezner noted in his February 25 testimony that:

> *If you don't have the dollar as the reserve currency, you're going to have to choose another one to be a reserve currency, and all of the other alternatives stink. There is just no other way to put it. . . . Once you eliminate the euro as a possibility, all of the other currency options really are nonstarters. The yen, the pound, the Swiss franc, they're all too small. The possibility that China floated of the Special Drawing Right [SDR] (issued by the IMF) is comical in the sense that the SDR is really the Esperanto of international currencies. It's not an actual real international currency.*[117]

Some economists have noted that even if China were to try to switch from the dollar as its reserve currency to the euro, that switch might also benefit the U.S. economy in one very specific way. Such a switch from the dollar would likely require China to drop its strict capital controls, allow the dollar to be traded within China, and allow the RMB to respond to the international currency market. Those dollars in the hands of Chinese citizens could then be used to purchase U.S. goods and services and to invest in the United States, activities that would likely reduce the U.S. trade deficit with China.[118] "The changes they would make to stop having to buy our bonds would be in America's interest," said Dr. Scissors. He added:

> *What would happen immediately upon capital controls being lifted is the bilateral trade surplus that China runs, our trade deficit, would drop a great deal. In particular, it would be much harder for China to subsidize what would be otherwise inefficient state firms so that U.S. goods would have greater market access, and Chinese exports would decline. . . . They have to take their balance of payments surpluses and put them in U.S. bonds. If their balance of payments surpluses decline because they've liberalized and stopped subsidizing everything, stopped being mercantilist in this way, then they have less money to put into U.S. bonds.*[119]

U.S. Options for a Course of Action

Witnesses suggested a variety of means to persuade or to force China to float the RMB or to, at least, allow it to rise in value. They included: (1) building a coalition of countries harmed by China's trade practices and collectively pressuring China to reform; (2) bringing a complaint to the World Trade Organization alleging an illegal subsidy or alleging nullification and impairment of a previous trade agreement; (3) bringing a countervailing duty case against imports from China that benefitted from China's currency manipulation; (4) appealing to the International Monetary Fund for enhanced surveillance of the RMB; (5) bringing the currency manipulation issue before the Group of 20 nations (G–20)[120]; or (6) declaring an emergency and imposing a surcharge tariff on imports in order to halt the outflow of foreign currency reserves, as President Nixon once did.

Dr. Johnson, who was critical of the IMF's lack of action on the Chinese currency issue, urged a new approach based on the G–20 and the World Trade Organization. Dr. Johnson and others suggested "a new multilateral process based around the World Trade Organization with legitimacy and authorization from the G–20." He said that the IMF "has completely dropped the ball, and we need to find a new approach."[121]

The 2010 report by the IMF on China was released in July. It showed that the IMF staff had concluded that the RMB "remains substantially below the level that is consistent with medium-term fundamentals" but that the IMF's executive board was divided on the issue.[122]

Added Dr. Johnson:

There's a limit to how much you should let countries do. There's a limit to what's fair, and there's a limit to what's reasonable, and China has gone beyond that. China is breaking the rules that it voluntarily agreed to when it joined the International Monetary Fund. There's no two ways around it. It has played the game well, so the IMF is not going to hold them accountable. We should recognize that; we should move on; we should find new mechanisms for holding them accountable in a responsible multilateral way, which is the way the U.S. has run the world economy, helped guide the world economy, since 1945, with great results.

To its credit, the G–20 did serve as a forum in 2009 to address structural imbalances in the global economy. In a statement aimed at the United States, the G–20 leaders admonished "members with sustained significant external deficits (to) pledge to undertake policies to support private savings and undertake fiscal consolidation while maintaining open markets and strengthening export sectors." The G–20 statement directed at China urged Beijing "to strengthen domestic sources of growth ... (including) increasing investment, reducing financial markets distortions, boosting productivity in service sectors, improving social safety nets, and lifting constraints on demand growth." [123]

One witness, Dr. Scissors, emphasized that the U.S. Treasury Department should do a better job of collecting data about the foreign holders of U.S. Treasury securities. Current statistics, he noted, "don't mean anything," because China holds a considerable but unknown amount of Treasury securities and other bonds through securities exchanges in other countries. Such Treasury bonds do not appear in U.S. Treasury statistics as being owned by China, because they are tabulated according to their sales location rather than their ultimate owner. In addition, China holds other dollar-denominated bonds, principally "agency" bonds issued by Fannie Mae and Freddie Mac. In fact, according to the latest available figures from June 2008 quoted by Dr. Scissors, China held more of such agency debt than it did Treasury securities.

"Transparency is a boring issue, but we have to have it," said Dr. Scissors. "If the Chinese change their rules, we've got to know what they're doing. Right now we have a distorted discussion because we don't know what they're doing." [124]

Implications for the United States

The United States need not fear implied or explicit threats by China to diversify from U.S. Treasury securities, to sell its large hoard of Treasuries, or to switch from the dollar to a new reserve currency. China has chosen to invest its $2.65 trillion in foreign exchange largely in dollars, because China considers this form of investment to be in its own interest. China does not invest in dollar holdings simply out of goodwill toward Washington. Chinese leaders, however, will occasionally suggest that they are willing to retaliate against the United States by using their Treasuries as leverage. But the dollar is the world's unofficial reserve currency and has a history of stability and safety. The pool of dollar-denominated debt investments is both liquid and deep. In addition, China's purchases of dollar-denominated debt are part of its system of capital controls, designed to keep the RMB undervalued as an aid to China's exports. For these reasons, China's threats to dump the dollar are not credible.

The United States would benefit from a more balanced trade relationship with China. Such a change would necessitate a revaluation of the RMB by allowing it to reach a market-determined value against the dollar. China has strongly resisted this reform. Both countries have, however, agreed within the G–20 framework to remove some of the impediments to a more balanced economic relationship. The United States has agreed to increase its level of savings and thereby reduce federal budget deficits. China has agreed to encourage domestic consumption instead of relying so strongly on exports and investment for future growth.

A more balanced relationship would benefit U.S. exporters who would have greater access to the Chinese market for their goods and services. This would help reduce the large U.S. trade deficit with China and would add jobs to the U.S. economy. A more balanced relationship would benefit the Chinese people by allowing them more choice in their investments and purchases. Greater government investments in education, pensions, and health care would also benefit Chinese citizens if China were to abandon its emphasis on exports.

Conclusions

- The United States need not fear a large sale of U.S. bonds by China nor a wholesale switch by China to investing in the bonds of another country. Because China holds such a large amount of dollar-denominated investments, including the bonds of U.S.-government owned Fannie Mae and Freddie Mac, and because the alternative investments in the euro and the yen are so limited, China has few alternatives to the dollar for its foreign reserves.

- Over the past decade, the government of the People's Republic of China has become the largest purchaser of U.S. debt. China implements a deliberate economic policy that relies on exports and foreign investment capital to amass a large current account surplus with the United States. That trade surplus is loaned back to the United States as part of China's deliberate policy.

- China manipulates the value of its currency, the RMB, by requiring its citizens, businesses, and exporters to trade their dollars for RMB. By limiting the dollars in circulation within China, the government can then set a daily exchange rate between the RMB and the dollar. China maintains an artificially low value for the RMB that is estimated to be between 20 percent and 40 percent lower than it would otherwise be, if it were allowed to respond to market forces.

- China's export-led growth strategy requires China to continue to run large trade surpluses with the United States and to recycle its accumulated dollars through the purchase of U.S. dollar-denominated securities. Recycling dollars back into the U.S. economy helps China to maintain the artificially low value of the

RMB. China's currency policy harms U.S. exporters and import-sensitive manufacturers in the United States though the policy aids consumers in the United States by keeping interest rates and prices low.

- A relaxation of China's currency policy would require China to end its capital controls. Easing China's capital controls would help to rebalance the economic relationship between the two countries.