U.S. Debt to China: Implications and Repercussions

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China's sense of economic strength has clearly affected both its foreign policy and its response to foreign criticism of its domestic policy. At the Copenhagen climate summit, for example, Chinese and American diplomats engaged in a furious war of words over who should pay what to whom. By the end of the summit, President Barack Obama had to barge in on a private meeting between Wen Jiabao and Indian Prime Minister Manmohan Singh to try to craft a compromise. According to numerous press reports, a mid-ranking Chinese official berated Obama for his rudeness at a follow-up meeting. On issues ranging from Iran to Taiwan to human rights to internet censorship, the Chinese leadership has responded with rhetorical invective and vague threats to sanction U.S. firms such as Boeing.

It should be stressed, however, that it is China's combination of strength and weakness helps to explain its recent bellicosity. The fundamentals of China's economy are strong, but compared to the United States, its weaknesses are also legion. The one-child policy has created a rapidly aging demographic profile. The Han Chinese elite is ever wary of simmering ethnic tensions that plague many of the border regions. Beijing faces periodic riots in Xinjiang and Tibet, daily worker unrest, unruly provincial leaders, and mounting ecological catastrophes. It has three enduring rivals (Japan, India and Vietnam) on its borders. For all the concern about Chinese cyberattacks, internet experts agree that the United States possesses more online offensive capabilities than any other country in the world. But by any conventional measure – GDP, GDP per capita, military capabilities, scientific and technological capacity – the United States remains the most powerful country in the world, and it's not close.

Perhaps China's greatest source of perceived strength is the size of its currency reserves and dollar-denominated debt. In response to the announced arms sale to Taiwan, Major General Luo Yuan recently told a Chinese magazine that, "we could sanction [the United States] using economic means, such as dumping some U.S. government bonds." the power of credit between great powers has been exaggerated in policy circles. Amassing capital can empower states in two ways – the ability to resist pressure from other actors, and the ability to pressure others. As states become creditors, they experience an undeniable increase in their autonomy. Capital accumulation strengthens the ability of creditor states to resist pressure from other actors.

When capital exporters try to use their financial power to compel other powerful actors into policy shifts, however, they run into greater difficulties. As the economic statecraft literature suggests, the ability to coerce is circumscribed. When targeted at small or weak states, financial statecraft can be useful; when targeted at great powers, such coercion rarely works. There are hard limits on the ability of creditors to impose costs on a target government. Expectations of future conflict have a dampening effect on a great power's willingness to concede. For creditors to acquire the necessary power to exert financial leverage, they become enmeshed in the fortunes of the debtor state.

More often than not, the attempt to use financial power to exercise political leverage against great powers has failed. Looking at recent history, what is surprising is not the rising power of creditors, but rather how hamstrung they have been in using their financial muscle. To date, China has translated its large capital surplus into minimal foreign policy gains. China's policy preferences have had no appreciable effect on either American foreign economic policy (sovereign wealth fund regulation, fiscal policy, protecting Chinese financial assets, intellectual property rights, trade openness) or national security policies (Taiwan, naval surveillance, Iran). The most that China's rising financial power affected was a tamping down of human rights rhetoric and a delay in a presidential meeting with the Dalai Lama. Indeed, if anything, Chinese bellicosity has triggered a mild anti-China backlash in recent weeks.

It is convenient that Chinese threats to dump dollars always seem to emanate from officials who have no influence whatsoever over China's foreign economic policy. For the medium term, a Chinese threat of decoupling from the United States is not an economically viable one. China is now the world's largest exporter, and the United States is their second-largest export market. Beijing's economic policies since the start of the Great Recession suggest that they are doubling down on their export-driven model of economic growth. China's economy remains heavily reliant on American markets. The tight coupling and complex interdependence between the United States and China will cause the incentive structures in global finance to more closely resemble the logic of nuclear deterrence. A "balance of financial terror" implies a more peaceful coexistence, but at the same time it is a relatively nervous coexistence

China's status as a capital exporter *has* increased its influence vis-à-vis international financial institutions and smaller states. From 2006 onwards Beijing effectively vetoed any discussion within the IMF to investigate whether China's currency was fundamentally misaligned. China vetoed Asian Development Bank loans to India because of a territorial dispute with New Delhi. In concert with the other BRIC economies, China agreed to contribute to IMF reserves. However, it did so through the purchase of IMF bonds denominated in Special Drawing Rights, a weighted basket of major currencies. In doing so, Beijing modestly advanced its goal of generating alternatives to the dollar as a reserve currency.

China's capital surplus also increased its ability to offer inducements to countries beyond the United States. In 2007 China's State Administration of Foreign Exchange (SAFE) purchased $300 million in Costa Rica bonds – and $150 million in untied aid – in exchange for that country switching its recognition from Taiwan to the government in Beijing. In February 2009, Chinese banks signed more than $40 billion worth of deals with state oil firms in Russia, Iran, Venezuela and Brazil, guaranteeing China a steady flow of oil for decades at reasonable rates. China was able to get good terms on these deals because these countries – unlike the United States – had greater difficulties obtaining foreign capital.

There are clear examples of China using its capital surplus to persuade nations to drop recognition of Taiwan or to secure long-term access to energy resources and strategic minerals. However, the prevalence of these trends is not clear. Beyond the Costa Rican example, there are no recent instances of China using its financial power to advance its Taiwan policy. Indeed, both Taiwan and the People's Republic have shied away from "bribe wars" in recent years to secure recognition from other countries. Similarly, on energy, China has begun to participate in market bids for energy resources in Iraq and elsewhere. In December 2009, for example, China National Petroleum Corporation (CNPC) won a contract to help develop Iraq's Halfaya oil field. CNPS is also involved in the development of Iraq's largest oil reserve at Rumaila.

Another concern is whether China will diversify from dollars or support an alternative global reserve currency. The head of the People's Bank of China drafted a white paper in March 2009 suggesting a shift away from the dollar as the world's reserve currency. Such a switch would have serious implications. Control over the reserve currency is a significant perquisite of monetary power in the global political economy. The McKinsey Global Institute recently estimated the reduction of the U.S. borrowing rate to be at least 50 basis points. They further calculated the net economic benefits of reserve currency status to range between $40 and $70 billion a year – a not insignificant sum.

The dollar is a "negotiated" currency at this point. This means, to paraphrase Tennessee Williams, that the dollar depends the kindness of strangers. Given the overhang of dollars held by central banks, sovereign wealth funds, and other government investment vehicles, there is some economic incentive to switch to a new reserve currency. If the rest of the world – and the Asia-Pacific region in particular – were to decide to coordinate around a different reserve currency, a switch would be possible. In September 2009, World Bank President Robert Zoellick warned, "The United States would be mistaken to take for granted the dollar's place as the world's predominant reserve currency. Looking forward, there will increasingly be other options to the dollar."

While a switch away from the dollar is always a latent possibility, the probability of it happening remains exceedingly remote. Even when an economic superpower is on the decline, reserve currencies are remarkably persistent entities. The network externalities of having a single unit of account and medium of exchange are massive. Every major historical and theoretical analysis of currencies stresses the rewards from creating a single focal point currency. A single reserve currency reduces the transactions costs of international exchange by ensuring a single unit of account. A common medium of exchange also reduces the political uncertainty that might exist with multiple reserve currencies.

China's adjustment costs in switching away from the dollar would be considerable. As the size of China's external portfolio increases, so have the Chinese leadership's domestic headaches. There is a fierce bureaucratic rivalry between finance ministry, central bank, and development bank officials – all of whom want to manage China's foreign exchange portfolio. Domestic discontent has been brewing about China's foreign investment strategy. Both officials and citizens debate whether holding so many dollars serves Chinese national interests. The political leadership has had to cope with the incongruity of investing trillions of government dollars in the developed world while tolerating significant pockets of domestic poverty. When these investments performed poorly, they faced fierce internal criticism. Officials at the China Investment Corporation received considerable domestic flak for their May 2007 investment in Blackstone, after that firm's stock value plummeted by 40 percent.

A decision by China to switch away from the dollar would lead to a dramatic fall in the value of its sizeable portfolio of external reserves. Officially, China declared $2.4 trillion in hard currency reserves at the end of 2009, but that does not count holdings beyond the People's Bank of China. In all, Chinese state investors are estimated to possess roughly $3 trillion in U.S. assets in September 2008, with approximately two-thirds invested in dollar-denominated debt. That figure has only increased in 2009. Any switch away from the dollar would cause that currency to fall in value – which would trigger concomitant losses to roughly two-thirds of China's holdings. Crudely put, a 10 percent appreciation of the renminbi would translate into a book loss of 3 percent of China's GDP in its foreign exchange reserves. Any financial losses from a switch away from the dollar – even if it was coordinated – would dramatically outweigh the losses from Blackstone.

The domestic political fallout would be equally great. While the initial decision might receive nationalist support, the economic costs would be significant. In addition to anger at dollar losses, the Chinese leadership would have to cope with the effects of a dollar depreciation. Any appreciation of the renminbi would hurt the Chinese export sector. The only way for China to make up for that lost demand would be to boost domestic consumption. China has been well aware of this need in recent years, but has been unable to increase personal consumption. Current projections have China's consumption remaining below 40% of GDP for the next fifteen years; even if extraordinary policy measures are implemented, anticipated consumption levels are projected to remain below 50%. China needs global export markets to thrive, which means it would bear massive adjustment costs from letting the dollar depreciate.

Perhaps the hardest constraint on a concerted change in currency regimes is finding an alternative to replace the dollar. In order to engage in coordinated action, the key actors would need to construct or discover a new focal point around which to develop a reserve currency. This leads to an awkward observation – the euro, the only truly viable substitute for the dollar, is not located in the Asia/Pacific region. It would be unlikely for the ASEAN +3 countries to agree to switch from the dollar to a new currency over which regional actors have no influence. This problem is compounded by the euro's weaknesses as a possible reserve currency. The European Union has no consolidated sovereign debt market. This places a severe liquidity constraint on euro markets. More importantly, the European Central Bank doesn't *want* the euro to become the new reserve currency. They have placed high barriers on any country joining the eurozone. In November 2009, ECB president Jean-Claude Trichet flatly stated, "The euro was not created to compete with the U.S. dollar or to replace the dollar as the international reserve currency…. The ECB does not campaign for the international use of the euro."

Other alternatives are even less attractive. Candidate currencies beyond the euro – the yen, pound, Swiss franc, Australian dollar – are based in markets too small to sustain the inflows that would come from reserve currency status. The yuan remains inconvertible for now, and China's leaders will be reluctant to give up their control over the country's financial sector in the future. A return to the gold standard in this day and age would be infeasible – the liquidity constraints and vagaries of supply would be too powerful. The People's Bank of China suggested using the Special Drawing Right as a template for a super-sovereign currency, but this is an implausible solution. As it currently stands, the SDR is not a currency so much as a unit of account. Even after the recent IMF authorization, there are less than $400 billion SDR-denominated assets in the world, which is far too small for a proper reserve currency. As one Chinese economist put it, the SDR is the Esperanto of currency options.

China's ability to charm the rest of the Asia-Pacific region into a coordinate shift away from the dollar for geopolitical reasons would be a difficult task. Any metric of power is a relative measure, and according to recent Chicago Council of Global Affairs surveys, U.S. soft power still outperforms China in the Asia-Pacific region. Furthermore, more aggressive Chinese 'soft balancing' against the United States would be likely to encourage a self-defeating countertrend – greater soft balancing against China. States on the Asia-Pacific periphery are likely to be more comfortable with a distant hegemon with a decent history of restraint than a local hegemon with a persistent history of territorial disputes.

On the currency question in particular, Beijing's post-2008 strategy of pegging the renminbi to the dollar has created tensions between China and other Asian exporters. The renminbi is strictly pegged to the dollar while other Pacific Rim currencies are pegged to a basket of currencies. Any fall in the dollar's value increases China's competitiveness at the expense of other exporters in the region. This forces other countries to either permit the appreciation in their own currencies (Japan), purchase more dollars to keep their currency from appreciating (ASEAN), or impose capital controls to forestall speculation about future appreciations (Taiwan). The situation likely triggers resentment against U.S. macroeconomic policy – but the greater object of ire is China's reluctance to allow the renminbi to appreciate against the dollar. This is not fertile ground upon which to build a geopolitical coalition against the United States.

History suggests the absence of a correlation between *realpolitik* concerns and the degree of cooperation among monetary authorities. In the years prior to the First World War, for example, central banking authorities cooperated across Europe to avert systemic crises even as foreign ministers engaged in balancing behavior on the continent. As Barry Eichengreen has observed, "In 1898 the Reichsbank and German commercial banks obtained assistance from the Bank of England and the Bank of France. In 1906 and 1907 the Bank of England, faced with another financial crisis, again obtained support from the Bank of France and the German Reichsbank. The Russian State Bank in turn shipped gold to Berlin to replenish the Reichsbank's reserves." Despite heightened concerns about geopolitical rivalries, central bankers continued to act to preserve the status quo in international monetary relations. It was not until the 1911 Agadir crisis that this pattern of international monetary cooperation began to break down, and the Reichbank in particular began to hoard specie in preparation for armed conflict.

Looking at the current situation in geopolitical terms, China in particular and the ASEAN +3 in general appear to be pursuing a "hedging" strategy rather than a revisionist strategy to topple the dollar. China's tactics suggest that it is not prepared to challenge the dollar's hegemonic status at any point in the near future. Recent steps allow Beijing to lay the groundwork for a long-term challenge, while placating domestic pressures in the short term. Institutionally, initiatives like the Chiang Mai Initiative have the potential to act as a possible substitute for the International Monetary Fund and other international financial institutions, creating the ability for Pacific Rim economies to forum-shop. Creating an "exit option" for the region enhances bargaining power within existing power structures. At the same time, these institutions remain embedded within the rules of IMF. Countries in the Pacific Rim can agree on the need for expanded regional influence, and emergency measures in case the international monetary regime falls apart. Beyond this hedge, however, the countries of the region appear to be perfectly content to operate within the existing rules of the game – including the dollar's reserve currency status.