Testimony submitted to U.S.-China Economic & Security Review Commission hearing on "US Debt to China: Implications and Repercussions". Panel I: China's Lending Activities and the US Debt, Thursday, February 25, 2010, 9am.

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A. Main Points

1) China is the largest holder of official foreign currency reserves in the world, currently estimated to be worth around $2.4 trillion – an increase of nearly $500 billion in the course of 2009 (on the back of a current account surplus of just under $300 billion, i.e., 5.8 percent of China's GDP, and a capital account surplus of around $100 billion). These reserves are accumulated through arguably the largest ever sustained intervention in a foreign exchange market – i.e., through The People's Bank of China buying dollars and selling renminbi, and thus keeping the renminbi-dollar exchange rate more depreciated than it would be otherwise.

2) China is also currently the second largest holder of US Treasury Securities – at the end of December 2009, it held $755.4 billion – just behind Japan (which had $768.8 billion).

3) The US Treasury data almost certainly understate Chinese holdings of our government debt because they do not reveal the ultimate country of ownership when instruments are held through an intermediary in another jurisdiction.

4) For example, UK holdings of US debt rose during 2009 from $130.9 billion to over $300 billion, despite the fact that the UK ran a substantial current account deficit last year. A great deal of this increase may be due to China placing off-shore dollars in London-based banks (Chinese, UK, or even US), which then buy US securities. China may also purchase US securities through other routes.

5) China is presumed by most observers to hold the majority of its incremental reserve accumulation in US Treasuries – this makes sense given that the other potential reserve currencies (euro, yen, and pound) all have serious issues – but according to the official US data, Chinese holdings peaked at $801.5 billion in May 2009 and fell by about $50 billion during the remainder of the year. A modest fall in true Chinese Treasury holdings – given slower reserve accumulation in December and the likely desire to diversify – is not completely implausible. But there are no indications that China is moving out of Treasuries in any large scale manner.

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[1] I thank Joe Gagnon for very helpful exchanges; see also the transcript of his recent interview on this topic. No one shares responsibility for the views expressed here, but the broader economic picture draws on joint work with James Kwak, particularly *13 Bankers* (forthcoming, March 2010) and "The Quiet Coup" (*The Atlantic*, April, 2009), and Peter Boone, including "The Next Financial Crisis: It's Coming and We Just Made It Worse" (*The New Republic*, September 8, 2009), "The Doomsday Cycle" (CEP/Vox, February 2010) and "Shooting Banks" (*The New Republic*, February 17, 2010). Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at http://BaselineScenario.com, where we also provide daily updates and detailed policy assessments for the global economy.

6) While the exact amount is not knowable based on publicly available information, a reasonable working assumption would be that China owns close to $1 trillion of US Treasury securities, i.e., perhaps half of the stock of treasuries in the hands of "foreign official" owners, which was $2.374 trillion (at the end of 2009, with the important caveat that other governments may also hold Treasuries through circuitous routes) and just under 1/7 of all US government securities outstanding ($7.27 trillion), of which $3.614 trillion was held by all foreign owners, official and private, at the end of 2009).

7) There is a perception that China's large dollar holdings confer upon that country some economic or political power vis-à-vis the United States and, in particular, that Chinese reserves prevent us from putting pressure on that country's authorities to revalue (i.e., appreciate) the renminbi. This view is incorrect and completely misunderstands the situation.

8) It is in the interests of both the United States and global economic prosperity that China discontinues its massive intervention in the market for renminbi. This intervention is a breach of China's international commitments (as a member of the International Monetary Fund) and constitutes a form of unfair trade practice.

9) If China were to end its intervention, the renminbi would appreciate substantially – likely in the region of 20-40 percent. China would also stop accumulating dollars (and other foreign assets).

10) The primary effect would therefore be an effective depreciation of the US dollar against the Chinese renminbi – and against all other countries' currencies that are implicitly pegged to the renminbi (more precisely, to the dollar rate with an eye on China's competitiveness). On a trade-weighted basis – and in real effective terms (despite the fact that the currencies of our other major trading partners float freely) – the dollar would also likely fall in value.

11) Such a movement in the dollar would help expand our exports and improve our ability to compete against imports; this would aid in the process of recovery, job creation, and broader adjustment in the US economy. Even a substantial movement in the dollar – e.g., a 20 percent depreciation in real effective terms, which is most unlikely – would have no noticeable effect on inflation and therefore would not force the Federal Reserve to increase interest rates. The "hard landing" scenario for the dollar – feared by analysts since the traumatic experiences of the 1970s – is unlikely for the US today, given the low level of inflation expectations and the high "output gap" (reflected in measured unemployment near 10 percent and true unemployment of at least 15 percent).

12) The effect on short-term US interest rates would therefore likely be minimal or nonexistent, particularly as the Federal Reserve currently aims to keep rates close to zero. The effect on longer-term US interest rates would also be small – and could be offset by the Federal Reserve, as it currently seeks to limit all benchmark interest rates (most recently affirmed by Chairman Bernanke this week).

13) In fact, the current stance of monetary policy – and the low, stable level of inflation expectations in the United States – makes this an ideal moment at which to press China to revalue its currency.

14) In another potential scenario, there is concern that China would threaten to reduce its purchases of US government securities without allowing its currency to appreciate. But if China continues to intervene to maintain its currency peg, it will accumulate foreign reserves – so they need to

hold increasing amounts of foreign assets of some kind. What else would the Chinese authorities buy?

a. If they buy other dollar denominated assets issued by US entities, this would push down spreads on those assets relative to Treasuries. This would directly help private US borrowers – thus stimulating growth in the US.

b. If they directly buy dollar denominated assets issued by non-US entities, this will still reduce spreads more broadly and help US borrowers – as there is a global market for dollar assets and there is not much high grade non-US dollar debt available for sale.

c. If they buy dollar equities – which is most unlikely – this would help the stock market, household balance sheets, and firms' access to funding (as well as helping to shift our economy from debt to more equity financing, which would a desirable move in any case.)

d. If they buy non-dollar assets, given that the Fed will keep interest rates near to zero, this will push down the value of the US dollar and help boost US growth. Such a move would produce protests from the eurozone and Japan, but this change in currency value would be solely China's responsibility.

15) If China stops buy foreign assets altogether, this would of course be equivalent to ending foreign exchange intervention. This is exactly the policy change that we should be seeking.

16) In addition, there are significant potential losses – in terms of net foreign assets – for China if their authorities sell Treasuries or otherwise undermine the value of the dollar (or intentionally roil markets) with negative comments. A depreciation of the dollar directly reduces the value of their foreign holdings and does not, under current circumstances, pose any kind of threat to the US.

17) There is still an open question of how best to push China to revalue the renminbi.

a. Bilateral negotiations, as championed for example by former Treasury Secretary Paulson, have achieved essentially nothing since 2002. This is not a promising way forward.

b. The International Monetary Fund (IMF) has proved itself incapable of calling China to account. The IMF's much vaunted "Surveillance Decision" is a failure and the general Fund mandate of "multilateral surveillance" has (again) proved to be a paper tiger. Working with the IMF on this issue is not worth any additional effort by the US government.

c. China is obviously a currency manipulator and should be so labeled by the US Treasury in its next report to Congress. China's threat to react by selling Treasuries is – as explained above – at worst a bluff and at best a way to help the US with a depreciation of the dollar. This bluff should be called.

18) This, of course, raises the issue of what the US should do beyond applying labels. Bilateral trade sanctions are never a good idea and can easily get out of hand. Given the failure of the existing multilateral mechanisms around the IMF, the US should take up this issue at the level of the G20 – there are two summits of leaders this year and plenty of support around the world for addressing China's exchange rate.

19) The most plausible proposal is to expand the mandate of the World Trade Organization – which should operate in this respect without the involvement of the IMF – in assessing exchange manipulation on the same basis as it deals with unfair trade practices (as proposed by Mattoo and Subramanian). While full implementation for such a rearrangement of responsibilities would take some years, concrete moves in this direction would concentrate the minds of the Chinese authorities in a potentially constructive manner.

B. Broader Economic Prospects

1) At the same time as the China "threat" is greatly exaggerated, there is little reason to be sanguine about near term US economic prospects.

2) In recent months, the US economy entered a recovery phase following the severe credit crisis-induced recession of 2008-09. While slower than it should have been based on previous experience, growth has surprised on the upside in the past quarter. This will boost headline year-on-year growth above the current consensus for 2010. We estimate the global economy will grow over 4 percent, as measured by the IMF's year-on-year headline number (their latest published forecast is for 3.9 percent), with US growth in the 3-4 percent range – calculated on the same basis.

3) But thinking in terms of these headline numbers masks a much more worrying dynamic. A major sovereign debt crisis is gathering steam in Europe, focused for now on the weaker countries in the eurozone, but with the potential to spillover also to the United Kingdom. These further financial market disruptions will not only slow the European economies – we estimate growth in the euro area will fall to around 0.5 percent Q4 on Q4 (the IMF puts this at 1.1 percent, but the January World Economic Outlook update was prepared before the Greek crisis broke in earnest) – it will also cause the euro to weaken and lower growth around the world.

4) There are some European efforts underway to limit debt crisis to Greece and to prevent the further spread of damage. But these efforts are too little and too late. The IMF also cannot be expected to play any meaningful role in the near term. Portugal, Ireland, Italy, Greece, and Spain will all come under severe pressure from speculative attacks on their credit. These attacks are motivated by fiscal weakness and made possible by the reluctance of relatively strong European countries to help out the PIIGS.

5) Financial market participants buy and sell insurance for sovereign and bank debt through the credit default swap market. None of the opaqueness of the credit default swap market has been addressed since the crisis of September 2008, so it is hard to know what happens as governments further lose their credit worthiness. Generalized counter-party risk – the fear that an insurer will fail and thus bring down all connected banks – is again on the table, as it was after the collapse of Lehman.

6) Again G7 (and G20) leaders are slow to see the risk. This time, given that they already used almost all their scope for fiscal stimulus, it will be considerably more difficult for governments to respond effectively if the crisis comes.

7) In such a situation, we should expect that investors scramble for the safest assets available – "cash", which means short-term US government securities. It is not that the US has anything approaching a credible medium-term fiscal framework, but everyone else is in much worse

shape. The major source of our vulnerability in this regard is nothing to do with China – it is about our ability, or inability, to resolve our over fiscal issues over the next 10-20 years.

8) Net exports have been a relative strength for the US economy over the past 12 months. This is unlikely to be the case during 2010.

9) In addition to this new round of global problems, the US consumer is beset by problems – including a debt overhang for lower income households, a soft housing market, and volatile asset prices. The savings rate is likely to fall from 2009 levels, but remain relatively high. Residential investment is hardly likely to recover in 2010 and business investment is too small to drive a recovery.

10) On a Q4-on-Q4 basis, the US will struggle to grow faster than 2 percent (the IMF forecast is for 2.6 percent). This within year pattern will likely involve a significant slowdown in the second half – although probably not an outright decline in output. The effects of fiscal stimulus will begin to wear off by the middle of the year and without a viable medium-term fiscal framework there is not much room for further stimulus – other than cosmetic "job creation" measures.

11) The Federal Reserve will start to wind down its extraordinary support programs for mortgage-backed securities, starting in the spring (although this may be delayed to some degree by international developments). The precise impact is hard to gauge, but this will not help prevent a slowdown in the second quarter.

12) On top of these issues, there is concern about the levels of capital in our banking system. The "too big to fail" banks are implicitly backed by the US government and for them the stress test of early 2009 played down the amount of capital they would need if the economy headed towards a "double-dip"-type of slowdown; the stress scenario used was far too benign. In addition, small and medium sized banks have a considerable exposure to commercial real estate, which continues to go bad.

13) Undercapitalized banks tend to be fearful and curtail lending to creditworthy potential borrowers. This may increasingly be the situation we face in 2010.

14) Emerging markets are also likely to slow in the second half of the year. Twice recently we have assessed whether these economies can "decouple" from the industrialized world (in early 2008 and at the end of 2008). In both cases, emerging markets – with their export orientation and, for some, dependence on commodity prices – were very much caught up in the dynamics of richer countries' cycle.

15) The IMF projects global growth, 4th quarter-on-4th quarter within 2010 at 3.9 percent, i.e., the same as their year-on-year forecast. We expect it will be closer to 3 percent.

16) Over a longer time-horizon, we will probably experience a global economic boom, based on prospects in emerging markets. However, with our current global financial structure, this brings with it substantial systemic risks.