



China's Holdings of U.S. Securities: Implications for the U.S. Economy

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July 30, 2009

Congressional Research Service

7-5700

www.crs.gov

RL34314

Summary

Given its relatively low savings rate, the U.S. economy depends heavily on foreign capital inflows from countries with high savings rates (such as China) to help promote growth and to fund the federal budget deficit. China has intervened heavily in currency markets to limit the appreciation of its currency, especially against the dollar. As a result, China has become the world's largest and fastest growing holder of foreign exchange reserves (FER). China has invested a large share of its FER in U.S. securities, which, as of June 2008, totaled \$1.2 trillion, making China the second largest foreign holder of U.S. securities (after Japan). These securities include long-term (LT) Treasury debt, LT U.S. agency debt, LT U.S. corporate debt, LT U.S. equities, and short-term debt. It is likely that China became the largest foreign holder of U.S. securities by the end of 2008. From June 2002 to June 2008, China's holdings of U.S. securities increased by over \$1 trillion—far more than that of any other nation.

U.S. Treasury securities are issued to finance the federal budget deficit. Of the public debt that is privately held, a little more than half is held by foreigners. As of May 2009, China's Treasury securities holdings were \$802 billion, accounting for 24.3% of total foreign ownership of U.S. Treasury securities, making it the largest foreign holder of U.S. Treasuries (it replaced Japan as the largest foreign holder in September 2008).

The current global financial crisis has raised considerable concern in the United States over the willingness of foreigners, including China, to continue to invest in U.S. securities, particularly Treasury securities, which will be used to help finance U.S. spending programs intended to promote economic recovery. During her first visit to China in February 2009, Secretary of State Clinton urged China to continue to buy U.S. Treasury Securities. In March 2009, Chinese Premier Wen Jiabao stated that he was "a little worried" about the safety of China's asset holdings in the United States. In addition, some Chinese government officials have called for replacing the dollar as the world's main foreign reserve currency. Given the sharp decline in China's net exports and foreign direct investment flows into China (major sources of China's foreign exchange reserves), it is not clear how much new U.S. debt China will purchase in the months ahead.

Data from the Department of Treasury indicate that in recent months China has sought to reduce its holdings of LT U.S. agency debt, while increasing its holdings of short-term U.S. Treasury securities—deemed by China to be more safe and secure. Some analysts contend that China might decide to unload a large share of its U.S. securities holdings, which could induce other foreign investors to sell off their U.S. holdings as well. Such a move could lead to a sharp depreciation of the dollar in international markets and force the United States to raise interest rates, which could significantly dampen U.S. economic growth, all else equal. Other observers counter that it would not be in China's economic interest to suddenly sell off its U.S. investment holdings. Doing so could lead to financial losses for the Chinese government, and any shocks to the U.S. economy caused by this action could ultimately hurt China's economy as well.

The issue of China's large holdings of U.S. securities is part of a larger debate among economists over how long the high U.S. reliance on foreign investment can be sustained, to what extent that reliance poses risks to the economy, and how to evaluate the costs associated with borrowing versus the benefits that would accrue to the economy from that practice.

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Because of its low savings rate, the United States borrows to finance the federal budget deficit and its capital needs in order to enjoy healthy economic growth. It therefore depends on countries with high savings rates, such as China, to invest some of its capital in the United States.

China's central bank is a major purchaser of U.S. assets, largely because of its exchange rate policy. In order to limit the renminbi's (China's currency) appreciation against the dollar, China's central bank must purchase U.S. dollars.¹ This has led China to amass a huge level of foreign exchange reserves (FER); these totaled \$2.13 trillion as of June 2009. Rather than hold dollars, which earn no interest, the Chinese central government has converted some level of its FER holdings into financial securities. Since foreign exchange holdings facilitate trade and prevent speculation against their currency, the central bank also holds securities from other foreign countries. The United States is a major destination of China's overseas investment. China is the second largest holder of U.S. securities, which include U.S. Treasury securities that are used to finance the federal budget deficit. Some U.S. policymakers have expressed concern that China's large holdings of U.S. securities may pose a risk to the U.S. economy should China stop purchasing those securities or attempt to divest itself of a large share of its holdings.

The recent financial crisis in the United States and the Administration's proposed plans to purchase troubled assets is expected to cost the government hundreds of billions of dollars, at least initially. This will require a substantial level of new government borrowing, some of which will likely be financed by foreign investors. China has been the largest foreign purchaser of new U.S. government debt in recent months.

This report examines the importance to the U.S. economy of China's investment in U.S. securities, as well as U.S. concerns over the possibility that China might unload a large share of those holdings and the potential implications such action could have for the U.S. economy. The report concludes that a large sell-off of Chinese Treasury securities holdings could negatively affect the U.S. economy, at least in the short-run. As a result, such a move could diminish U.S. demand for Chinese products and thus could lower China's economic growth as well. The issue of China's large holdings of U.S. securities is part of a broader question that has been raised by many economists: what are the implications of the heavy U.S. reliance on foreign investment to maintain healthy economic growth and to finance the budget deficit?²

China's Foreign Exchange Reserves

As indicated in **Table 1**, China's foreign exchange reserves have increased sharply in recent years, both in absolute terms and as a percent of gross domestic product (GDP). These rose from \$216 billion in 2001 to \$1,528 billion in 2007, to \$1,946 billion in 2008. China's reserves as a percent of GDP grew from 15.3% in 2001 to 45% in 2008—an unusually high level for a large economy. However, China's accumulation of reserves appears to be slowing, in large part

¹ China's accumulation of foreign exchange reserves has also occurred because of large annual current account trade surpluses, high levels of foreign direct investment in China, and inflows of "hot money" from overseas investors who anticipate that the Chinese government will appreciate the renminbi in the near future. For additional information, see CRS Report RL32165, *China's Currency: Economic Issues and Options for U.S. Trade Policy*, by Wayne M. Morrison and Marc Labonte.

² For a discussion of the implications of a possible global sell-off of U.S. securities, see CRS Report RL34319, *Foreign Ownership of U.S. Financial Assets: Implications of a Withdrawal*, by James K. Jackson.

because of the impact of the global financial crisis on China (such as on its exports and flows of foreign direct investment). From the end of December 2008 to the end of June 2009, China's reserves grew by \$186 billion.³

Table 1. China's Foreign Exchange Reserves: 2001- June 2009

Year	Billions of U.S. Dollars	As a % of Chinese GDP
2001	215.6	16.3
2002	291.1	20.0
2003	403.3	24.6
2004	609.9	31.6
2005	818.9	36.5
2006	1,068.5	40.2
2007	1,528.2	45.2
2008	1,946.0	45.0
June 2009	2,131.6	NA

Source: Global Insight and Chinese State Administration of Foreign Exchange.

Note: Year-end or end month values.

A listing of the world's top five holders of FER as of June 2009 is shown in **Table 2**. Not only was China by far the world's largest FER holder, its accumulation of additional reserves from 2006-June 2009 (\$1.06 trillion) was significantly larger than the combined FER increases of the other four major holders—Japan, Russia, Taiwan, and India (\$311.7 billion).⁴ According to the IMF, as of December 2008, China accounted for 29% of the world's FER.⁵

³ In comparison, China's foreign exchange reserves grew by \$281 billion during the first half of 2008 over its holdings at the end of December 2007.

⁴ China overtook Japan in 2006 to become the world's largest holder of FER.

⁵ Total foreign exchange reserves for all countries at the end of 2008 were estimated by the IMF at \$6.5 trillion; about 40% of these were held in dollar-denominated assets.

Table 2. Top 5 Holders of Foreign Exchange Reserves and Changes to Holdings From 2006-June 2009

Country	Reserves (billions of U.S. dollars)			
	2006	2007	2008	June 2009
China	1,068.5	1,528.2	1,946.0	2,131.6
Japan	879.7	948.4	1,003.3	988.5
Russian Federation	295.3	386.2	406.2	365.4
Taiwan	266.1	270.0	291.7	317.6
India	170.2	266.6	246.6	251.5

Sources: IMF International Financial Statistics, and Central Bank of the Republic of China (Taiwan).

Note: Ranked according to total holdings as of June 2009. Annual data are end year.

China's Holdings of U.S. Securities⁶

China is a major purchaser of U.S. financial securities because of its exchange rate policy. In order to mitigate the renminbi's appreciation against the dollar, China's central bank must purchase dollars. Rather than hold dollars, which earn no interest, the Chinese central government has converted some level of its foreign exchange holdings into financial securities. Since foreign exchange holdings facilitate trade and prevent speculation against their currency, the central bank also holds securities from other foreign countries.

There are no official estimates of what share of China's foreign reserves are held in dollar-denominated assets (assets that were bought with dollars and are cashed in dollars), but the Treasury Department conducts an annual survey of foreign portfolio holdings of U.S. securities by country, and reports data for the previous year as of the end of June.⁷ The report does not distinguish between government and private holdings of U.S. securities. U.S. securities include long-term (LT) U.S. Treasury securities, LT U.S. government agency securities,⁸ LT corporate securities (some of which are asset-backed), equities (such as stocks), and short-term debt.⁹

According to the latest Treasury survey of portfolio holdings of U.S. securities (issued in February 2009), China's total holdings as of June 2008 were \$1,205 billion, which were \$283

⁶ For additional information on foreign ownership of U.S. securities, see CRS Report RL32462, *Foreign Investment in U.S. Securities*, by James K. Jackson.

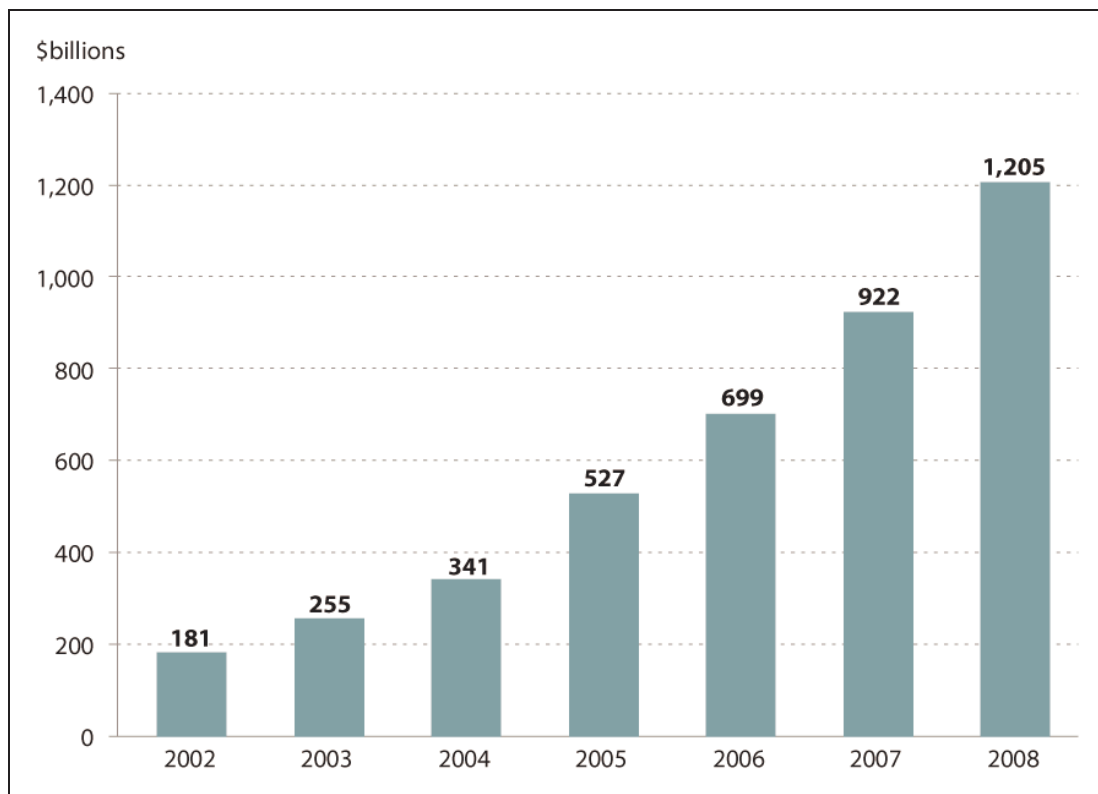
⁷ Note, Treasury's annual survey does not include data on foreign direct investment (FDI) in the United States, which measures foreign ownership or investment in U.S. businesses. China's total FDI in the U.S. at the end of 2007 was \$1.1 billion (on a historical cost basis), according the U.S. Bureau of Economic Analysis. Since these types of assets cannot be liquidated rapidly, they are not included in this report.

⁸ Agency securities include both federal agencies and government-sponsored enterprises created by Congress (e.g., Fannie Mae and Freddie Mac) to provide credit to key sectors of the economy. Some of these securities are backed by assets (such as home mortgages).

⁹ LT securities are those with no stated maturity date (such as equities) or with an original term to maturity date of more than one year. Short-term debt includes U.S. Treasury securities, agency securities, and corporate securities with a maturity date of less than one year.

billion (or 31%) larger than June 2007 levels, and were nearly five times 2003 levels (see **Figure 1**).¹⁰ These increases were significantly more than that of any other major foreign holder.¹¹

Figure 1. China's Holdings of U.S. Securities: June 2002-June 2008
\$billions



Source: U.S. Treasury Department, Preliminary Report On Foreign Holdings Of U.S. Securities At End-June 2008.

As indicated in **Table 3**, China was the second largest foreign holder of U.S. securities, after Japan as of June 2008.¹² China likely became the largest foreign holder in late 2008 or early 2009. China's main holdings were in LT government agency securities and LT Treasury securities (see **Figure 1**). This appears to indicate that the Chinese government was pursuing what it perceived to be a relatively low-risk investment strategy. In contrast, most of the United Kingdom's securities holdings were in corporate debt and equities. China's holdings of U.S. securities accounted for 11.7% of total foreign holdings of U.S. securities as of June 2008 (up from 9.4% as of June 2007).

¹⁰ Data on China's holdings of U.S. securities exclude holdings by Hong Kong (which totaled \$147 billion as of June 2008) and Macao. These entities, though part of China, are reported separately by Treasury.

¹¹ In comparison, Japan's holdings grew by only \$53 billion.

¹² According to the Treasury Department, data on foreign holdings of U.S. securities should be treated with caution, due to the difficulty in obtaining accurate information on the *actual* foreign owners of U.S. securities. For example, chains of foreign financial intermediaries may be involved in the custody or management of these securities.

Table 3. Top Three Foreign Holders of U.S. Securities as of June 2008

(\$ billions)

Type of Security	Total	LT Treasury	LT Government Agency	LT Corporate	Equities	Short Term
Japan	1,250	568	270	148	199	66
China	1,205	522	527	26	100	30
United Kingdom	864	45	26	394	376	24
World Total	10,324	2,210	1,464	2,820	2,969	861
Change in China's Holdings over June 2007	283	55	151	-2	71	7
China's Holdings as a Percent of World Total (%)	11.7	23.6	36.0	0.9	3.4	3.5

Source: U.S. Treasury Department, *Preliminary Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2008*, February 2009.

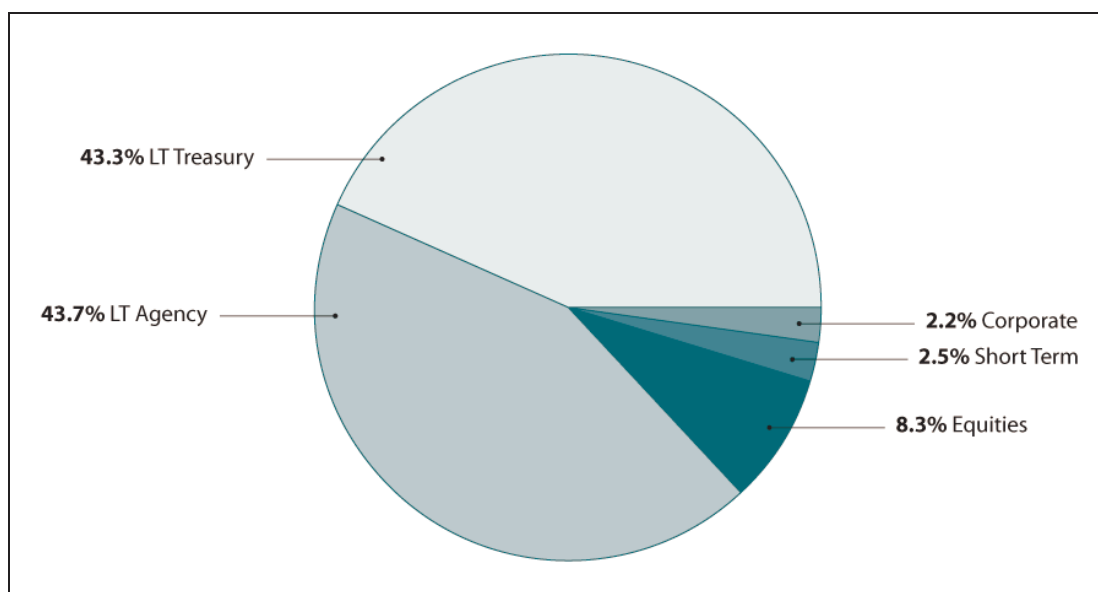
Note: LT securities are those with no stated maturity date (such as equities) or with an original term to maturity date of more than one year. Short term securities have a maturity period of less than one year.

Although the Chinese government does not make public the dollar composition of its foreign exchange holdings, many analysts estimate this level to be around 70%.¹³ If this figure is correct, China's holdings of U.S. securities may have reached \$1.36 trillion or higher as of December 2008, and \$1.49 trillion as of June 2009.¹⁴

LT U.S. agency debt and LT U.S. Treasury securities and were the largest categories of China's holdings of U.S. securities (at 43.7% and 43.3%, respectively of total holdings as of June 2008). Chinese holdings of U.S. agency debt from June 2007 to June 2008 increased by \$151 billion (all of this increase was in asset-backed securities) and accounted for over half of China's increased holdings of total U.S. securities in 2008.¹⁵ China's new purchases of new agency debt were bigger than that of any other foreign country over this one year period. China is by far the largest foreign owner of U.S. agency debt, accounting for 36% of total foreign holdings as of June 2008 (up from 29% as of June 2007). China also increased its holdings in U.S. equities by \$71 billion.

¹³ See testimony of Brad Setser, Senior Economist, Roubini Global Economics and Research Associate, Global Economic Governance Programme, University College, Oxford, before the House Budget Committee, *Foreign Holdings of U.S. Debt: Is our Economy Vulnerable?*, June 26, 2007, p. 11. In addition, the *People's Daily Online* (August 28, 2006) estimated China's dollar holdings to total FER at 70%.

¹⁴ Some analysts contend that the Chinese government undercounts the total level of its foreign exchange reserves and thus, its holdings of U.S. securities could be even higher.

Figure 2. Composition of China's Holdings of U.S. Securities as of June 2008

Source: Department of Treasury.

Note: LT stands for long-term debt.

It is not clear to what extent China's investments were exposed to U.S. sub-prime mortgage securities, but they are likely to be small relative to their total investments. As seen in **Table 3**, China has invested \$527 billion in long-term agency securities, most—but not all—of which is likely to be debt issued by Fannie Mae and Freddie Mac. *The South China Morning Post* (September 25, 2008) estimated that Chinese banks held \$9.8 billion in U.S. sub-prime loans at the end of 2007 and \$25 billion in Fannie Mae and Freddie Mac securities as of June 30, 2008. Whatever risk China faced from its holdings of Freddie Mac and Fannie Mae mortgage-backed securities was greatly reduced in September 2008 when these two institutions were placed in conservatorship by the Federal Government and thus have government backing, assuming China intends to hold these securities long term. The Bank of China (one of China's largest state-owned commercial banks) reportedly had the largest exposures to U.S. sub-prime mortgage-backed securities among any banks in Asia when the financial crisis began. However, it reported that holdings of such securities as a share of its total investment securities portfolio were reduced from 3.5% in March 2008 to 1.4% in October 2008.¹⁶

Complete data are not yet available that would indicate how the U.S. sub-prime and crisis and ensuing global financial crisis have affected China's purchases of U.S. securities, especially since the extent of these crises became more apparent after June 2008. For example, in September 2008, Fannie Mae and Freddie Mac were placed in conservatorship by the Federal Government. Press reports indicate that China, which is believed to hold a large amount of Freddie Mac and Fannie Mae securities, was greatly concerned over the financial safety of its holdings when it became clear in July 2008 that both institutions were in serious financial trouble. The U.S. government takeover of Freddie Mac and Fannie Mae provided explicit U.S. government backing

¹⁶ The Bank of China either reduced its holdings or wrote off the losses.

to these securities. However, the Treasury Department's monthly data on net purchases of U.S. LT securities indicate that China has sharply reduced its holdings of U.S. agency debt since June 2008. As indicated in **Table 4**, China's net purchases of U.S. agency debt totaled \$24.2 billion for April-June 2008; but from July-September 2008, net purchases fell by \$18.2 billion. They declined by \$10.4 billion from October-December 2008 and by \$5.2 billion during the first three months of 2009. Overall, China's net purchases of LT agency debt has fallen by \$34 billion from June 2008-March 2009.¹⁷ It appears that China has sharply increased its purchases of short-term (less than one year maturity) securities, deemed to be more safe and secure.

Table 4. China's Net Purchases of LT U.S. Securities Since June 2008

\$millions

	Total U.S. LT Securities	Treasury Bonds	Agency Bonds	Corporate Bonds	Corporate Stocks
Three Months Ending in March 2009	9,527	14,499	-5,219	126	121
Three Months Ending in December 2008	-2,738	4,233	-10,418	3,179	268
Three Months Ending in September 2008	15,143	36,098	-18,421	-1,810	-724
Three Months Ending in June 2008	80,235	24,239	36,263	20,002	-269

Source: Department of Treasury.

Notes: The data series in this table reflects the country origin of the transaction rather than the country of origin of the purchaser (which is what the Treasury Department uses in its annual report on Foreign Portfolio Holdings of U.S. Securities).

China's Ownership of U.S. Treasury Securities¹⁸

U.S. Treasury securities are the main vehicle the U.S. government uses to finance the federal debt, which totaled \$11.1 trillion at the end of March 2009. Of this amount, 43% was held by U.S. government trust funds and 57% was privately held. Of the total level of privately-held U.S. Treasury securities (\$6.3 trillion), foreigners owned 52% of the total (\$3.3 trillion).¹⁹ China's holdings of U.S. Treasury securities (as of March 2009) accounted for 12.1% of total private holdings (including foreign governments and citizens) of U.S. Treasury securities and 6.9% of total U.S. public debt securities (combined public and private).²⁰

¹⁷ This data reflects the country origin of the transaction rather than the country of origin of the purchaser (which is what the Treasury Department uses in its annual report on Foreign Portfolio Holdings of U.S. Securities). A large share of China's purchases of U.S. securities are done outside of China. Thus, these data may not reflect China's actual total purchases of U.S. securities.

¹⁸ For a general discussion of foreign ownership of U.S. debt, see CRS Report RS22331, *Foreign Holdings of Federal Debt*, by Justin Murray and Marc Labonte.

¹⁹ U.S. Treasury Department, Financial Management Service, *Ownership of Federal Securities*, available at <http://www.fms.treas.gov/bulletin/index.html>.

²⁰ Although yields on U.S. Treasury securities are relatively low compared to other types of investment, they are also considered to be relatively low in risk. Thus they are viewed by many central banks to be a safe investment for their FER.

As indicated in **Table 5**, China has been one of the largest annual purchasers of U.S. Treasury securities in recent years. From December 2002 to May 2009, China's holdings increased by \$683 billion, and its share of total foreign holdings of U.S. Treasury securities rose from 9.6% to 24.3%. In September 2008, China overtook Japan to become the largest foreign holder of U.S. Treasury securities (in December 1997, China was the 7th largest holder).²¹ From June 2008 to May 2009, China's holdings increased by \$266 billion (or 50%), by far the largest dollar increase of any country (see **Table 6**). In addition, China accounted for 38% of net new foreign holdings of U.S. Treasury securities during this time.

Table 5. China's Year-End Holdings of U.S. Treasury Securities: 2002-May 2009

\$ billions and as a percent of total foreign holdings

	2002	2003	2004	2005	2006	2007	2008	May 2009
China's Holdings (\$billions)	118.4	159.0	222.9	310.0	396.9	477.6	727.4	801.5
Holdings as a % of Total Foreign Holdings	9.6%	10.4%	12.1%	15.2%	18.9%	20.3%	23.6%	24.3

Source: U.S. Treasury Department.

Table 6. Major Foreign Holders of U.S. Treasury Securities: May 2009

(\$ billions)

	June 2008	May 2009	Change in the Value of its Holdings from June 2008-May 2009 (\$)	Holdings as a Share of Total Foreign Holdings as of May 2009 (%)
China	535.1	801.5	266.4	24.3
Japan	628.0	677.2	49.2	20.6
Caribbean Banking Centers	106.6	194.8	88.2	5.9
Oil Exporters ^a	159.5	192.9	33.4	5.9
United Kingdom	55.0	163.8	108.8	5.0
Total Foreign Holdings	2,587.2	3,293.1	705.9	--

Source: Department of Treasury, *Major Foreign Holders of Treasury Securities Holdings*, July 16, 2009.

a. Oil exporters include Ecuador, Venezuela, Indonesia, Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates, Algeria, Gabon, Libya, and Nigeria.

Note: Data are based on surveys which are done annually or biannually. Each new survey generally revises data for a few previous months, but not for the entire historical data series. Thus, time series data should be viewed with caution.

²¹ Treasury constantly revises its estimates of foreign holdings of U.S. securities, but limits the revisions to only the prior years. Thus, comparisons of historical Treasury data should be viewed with caution.

U.S. Concerns Over China's Large Holdings of U.S. Securities

Some U.S. policymakers have recently raised concerns that China, for economic reasons (such as concerns over the safety of its current holdings of U.S. securities), might seek to liquidate such assets or significantly cut back on purchases of new securities. These fears have been heightened as a result of the U.S. sub-prime mortgage crisis and the subsequent global financial crisis.²² During her visit to China on February 21, 2009, Secretary of State Hillary Rodham Clinton stated that she appreciated “greatly the Chinese government's continuing confidence in the United States Treasuries,” and she urged the government to continue to buy U.S. debt. On March 13, 2009, Chinese Premier Wen Jiabao at a news conference stated: “We lent such huge fund [sic] to the United States and of course we're concerned about the security of our assets and, to speak truthfully, I am a little bit worried.”²³ Chinese officials reportedly raised these concerns during the July 2009 session of the U.S.-China Strategic and Economic Dialogue (S&ED); the United States pledged to increase U.S. savings levels. Many analysts (including some in China) have questioned the wisdom of China's policy of investing a large level of foreign exchange reserves in U.S. government securities, which offer a relatively low rate of return, when China has such huge development needs at home. On March 24, 2009, the governor of the People's Bank of China, Zhou Xiaochuan, published a paper calling for the replacing the U.S. dollar as the international reserve currency with a new global system controlled by the International Monetary Fund.²⁴

What If China Reduces its Holdings of U.S. Securities?²⁵

As the previous data illustrate, China has accumulated large holdings of U.S. assets in recent years. These accumulations are the result of U.S. borrowing to finance its large trade deficit with China (the gap between U.S. exports and Chinese imports). All else equal, Chinese government purchases of U.S. assets increases the demand for U.S. assets, which reduces U.S. interest rates.

The financial crisis and the large increase in the U.S. budget deficit have brought renewed concerns that China might decide to reduce its holdings of U.S. securities. If China attempted to reduce its holdings of U.S. securities, they would be sold to other investors (foreign and domestic), who would presumably require higher interest rates than those prevailing today to be enticed to buy them. One analyst estimates that a Chinese move away from long-term U.S. securities could raise interest rates by as much as 50 basis points.²⁶ Higher interest rates would

²² See CRS Report RL34742, *The Global Financial Crisis: Analysis and Policy Implications*, coordinated by Dick K. Nanto.

²³ Xinhua News Agency, March 13, 2009.

²⁴ *Financial Times*, “China calls for new reserve currency,” March 24, 2009.

²⁵ From the perspective of the macroeconomic effects on U.S. investment, interest rates, and so on, it does not matter what type of U.S. security is purchased when foreign capital flows to the United States. Thus, Chinese purchases of all types of U.S. securities (not just Treasury securities) should be considered when attempting to understand the impact China's investment decisions have on the U.S. economy.

²⁶ Testimony of Brad Setser before the House Budget Committee, *Foreign Holdings of U.S. Debt: Is our Economy* (continued...)

cause a decline in investment spending and other interest-sensitive spending. All else equal, the reduction in Chinese Treasury holdings would cause the overall foreign demand for U.S. assets to fall, and this would cause the dollar to depreciate. If the value of the dollar depreciated, the trade deficit would decline, as the price of U.S. exports fell abroad and the price of imports rose in the United States.²⁷ The magnitude of these effects would depend on how many U.S. securities China sold; modest reductions would have negligible effects on the economy given the vastness of U.S. financial markets.

Since China held \$1.2 trillion of U.S. government assets as of June 2008 (and possibly \$1.5 trillion as of June 2009), any reduction in its U.S. holdings could potentially be large. If there were a large reduction in its holdings, the effect on the U.S. economy would still depend on whether the reduction were gradual or sudden. It should be emphasized that economic theory suggests that a *slow decline* in the trade deficit and dollar would not be troublesome for the overall economy. In fact, a slow decline could even have an expansionary effect on the economy, if the decrease in the trade deficit had a more stimulative effect on aggregate demand in the short run than the decrease in investment and other interest-sensitive spending resulting from higher interest rates. Historical experience seems to bear this out—the dollar declined by about 40% in real terms and the trade deficit declined continually in the late 1980s, from 2.8% of GDP in 1986 to nearly zero during the early 1990s. Yet economic growth was strong throughout the late 1980s.

A potentially serious short-term problem would emerge if China decided to *suddenly* reduce their liquid U.S. financial assets significantly. The effect could be compounded if this action triggered a more general financial reaction (or panic), in which all foreigners responded by reducing their holdings of U.S. assets. The initial effect could be a sudden and large depreciation in the value of the dollar, as the supply of dollars on the foreign exchange market increased, and a sudden and large increase in U.S. interest rates, as an important funding source for investment and the budget deficit was withdrawn from the financial markets. The dollar depreciation by itself would not cause a recession since it would ultimately lead to a trade surplus (or smaller deficit), which expands aggregate demand.²⁸ (Empirical evidence suggests that the full effects of a change in the exchange rate on traded goods takes time, so the dollar may have to “overshoot” its eventual depreciation level in order to achieve a significant adjustment in trade flows in the short run.)²⁹ However, a sudden increase in interest rates could swamp the trade effects and cause (or worsen) a recession. Large increases in interest rates could cause problems for the U.S. economy, as these increases reduce the market value of debt securities, cause prices on the stock market to fall, undermine efficient financial intermediation, and jeopardize the solvency of various debtors and creditors. Resources may not be able to shift quickly enough from interest-sensitive sectors to

(...continued)

Vulnerable?, June 26, 2007. Brad Setser is Senior Economist, Roubini Global Economics, and Research Associate, Global Economic Governance Programme, University College, Oxford. Setser does not detail how much U.S. debt he assumes China would sell to reach his estimate.

²⁷ The extent that the dollar declined and U.S. interest rates rose would depend on how willing other foreigners were to supplant China's reduction in capital inflows. A greater willingness would lead to less dollar depreciation and less of an increase in interest rates, and vice versa.

²⁸ A sharp decline in the value of the dollar would also reduce living standards, all else equal, because it would raise the price of imports to households. This effect, which is referred to as a decline in the terms of trade, would not be recorded directly in GDP, however.

²⁹ Since the decline in the dollar would raise import prices, this could temporarily increase inflationary pressures. The effect would likely be modest, however, since imports are small as a share of GDP and import prices would only gradually rise in response to the fall in the dollar.

export sectors to make this transition fluid. The Federal Reserve could mitigate the interest rate spike by reducing short-term interest rates, although this reduction would influence long-term rates only indirectly, and could worsen the dollar depreciation and increase inflation.

The likelihood that China would suddenly reduce its holdings of U.S. securities is questionable because it is doubtful that doing so would be in China's economic interests. First, a large sell-off of China's U.S. holdings could diminish the value of these securities in international markets, which would lead to large losses on the sale, and would, in turn, decrease the value of China's remaining dollar-denominated assets.³⁰ This would also occur if the value of the dollar were greatly diminished in international currency markets due to China's sell-off.³¹ Second, such a move would diminish U.S. demand for Chinese imports, either through a rise in the value of the renminbi against the dollar or a reduction in U.S. economic growth (especially if other foreign investors sold their U.S. asset holdings, and the United States was forced to raise interest rates in response).³² According to some estimates, nearly one quarter of Chinese exports went to the United States in 2008. A sharp reduction of U.S. imports from China could have a significant impact on China's economy, which heavily depends on exports for its economic growth (and is viewed by the government as a vital source of political stability).³³ Finally, any major action by the Chinese government that destabilized (or further destabilized) the U.S. economy (whether deliberate or not) could provoke "protectionist" sentiment in the United States against China.

U.S. financial markets experienced exceptional turmoil beginning in August 2007. Over the following year, the dollar declined by almost 8% in inflation-adjusted terms—a decline that was not, in itself, disruptive. But as the turmoil deepened and spread to the rest of the world, the value of the dollar began rising. Interest rates on U.S. Treasuries fell close to zero, implying excessive investor demand. Other interest rates also remained low, although access to credit was limited for some. Although comprehensive data will not be available for some time, a "sudden stop" in capital inflows does not appear to have been a feature of the downturn. Problems recently experienced in U.S. financial markets have been widely viewed as "once in a lifetime" events. If these events failed to cause a sudden flight from U.S. assets and an unwinding of the CA deficit by China or other countries, it is hard to imagine what would.

Concluding Observations

Many economists argue that concerns over China's holdings of U.S. securities represent part of a broader problem for the U.S. economy, namely its dependence on foreign saving to finance its investment needs and federal budget deficits.³⁴ The large U.S. current account deficit (the

³⁰ Since there are many other holders of U.S. assets, it is possible that if China believed a decline in asset values was imminent, it could minimize its losses by dumping its U.S. assets first, however.

³¹ Selling off U.S. dollar assets could cause the renminbi to appreciate against the dollar, which would lower the value of remaining U.S. assets since the assets are dollar-denominated.

³² In addition, if a "dollar collapse" occurred, U.S. imports from other major trade partners would decline, which could slow their economies. This in turn could weaken their demand for Chinese products.

³³ Although a falling dollar may harm China's short-term growth via reduced Chinese exports (and export sector-related employment), it would also improve China's terms of trade with the United States, raising China's overall consumption since it could now spend less to acquire the same amount of American goods (which would also create jobs in other sectors of the economy because of increased consumer purchasing power).

³⁴ Nations (such as the United States) that fail to save enough to meet their investment needs must obtain savings from other countries with high savings rates (such as China). By obtaining resources from foreign investors for its (continued...)

manifestation of the high U.S. saving/investment gap) cannot be sustained indefinitely because the U.S. net foreign debt cannot rise faster than GDP indefinitely.³⁵ Some economists argue that at some point foreign investors may view the growing level of U.S. foreign debt as unsustainable or more risky, or they may no longer view U.S. securities as offering the best return on their investment, and shift investment funds away from U.S. assets, thus forcing U.S. interest rates to rise to attract needed foreign capital. This would result in higher interest rates and lower investment rates, all else equal, which would reduce long-term growth.³⁶ A reliance on foreign governments such as China to finance the U.S. trade deficit by increasing their foreign exchange reserves may prolong the necessary adjustment process. Other economists contend that, although the low U.S. savings rate is a problem, the U.S. current account deficit and high levels of foreign capital flows to the United States are also reflections of the strength of the U.S. economy and its attractiveness as a destination for foreign investment, and therefore discount the likelihood that foreign investors will suddenly shift their capital elsewhere.³⁷

The United States continues to press China to make its currency policy more flexible so that the renminbi will appreciate more significantly against the dollar and to adopt policies that promote domestic consumption as a major source of China's economic growth (as opposed to export and fixed investment-led growth that has resulted from China's currency policy).³⁸ This is viewed as a major step towards reducing global trade imbalances, including the large U.S.-China trade imbalance. However, in order for that to occur, the United States must also boost its level of savings in the long run. If China consumed more and saved less, it would have less capital to invest overseas, including in the United States. Thus, if the United States did not reduce its dependence on foreign savings for its investment needs, and China reduced its U.S. investments, the United States would need to obtain investment from other countries, and the overall U.S. current account balance would likely remain relatively unchanged.

Some U.S. policymakers have expressed hope that China will increase its U.S. debt holdings in order to help the Federal government pay for its financial rescue plan and future stimulus packages.³⁹ But others have expressed concern that becoming more reliant on Chinese purchases of U.S. debt would increase China's political leverage over the United States and may make it more difficult for the United States to induce China to appreciate its currency more quickly and to make other needed reforms to its economy. Some analysts contend that economic factors in China, such as decreased exports and foreign direct investment flows to China, may sharply limit

(...continued)

investment needs, the United States is able to enjoy a higher rate of consumption than it would if investment were funded by domestic savings alone. The inflow of foreign capital to the United States is equivalent to the United States borrowing from the rest of the world. The only way the United States can borrow from the rest of the world is by importing more than it exports, which produces a trade (and current account) deficit.

³⁵ The current account deficit rose from \$389.4 billion in 2002 to \$811.5 billion in 2006, and as a percent of GDP, it increased from 4.4% to 6.1%, respectively. The Economist Intelligence Unit estimates that the current account deficit as a percent of GDP 5.3% in 2007 and to 4.8% in 2008.

³⁶ See CRS Report RL33186, *Is the U.S. Current Account Deficit Sustainable?*, coordinated by Marc Labonte.

³⁷ See Council of Economic Advisors, Economic Report of the President, *The U.S. Capital Surplus*, February 2006, p. 144.

³⁸ In November, the Chinese government announced it would implement a two-year \$586 billion stimulus package, mainly dedicated to infrastructure projects.

³⁹ See CRS Report RS22984, *China and the Global Financial Crisis: Implications for the United States*, by Wayne M. Morrison.

its accumulation of additional foreign exchange reserves, which in turn could slow or halt China's purchases of U.S. securities.

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