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

Wayne M. Morrison
Specialist in Asian Trade and Finance

Marc Labonte
Specialist in Macroeconomic Policy

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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 meet its domestic investment needs and to fund the federal budget deficit. The willingness of foreigners to invest in the U.S. economy and purchase U.S. public debt has helped keep U.S. real interest rates low. However, many economists contend that U.S. dependency on foreign savings exposes the U.S. economy to certain risks, and some argue that such low-cost capital inflows were a contributing factor to the U.S. housing bubble and subsequent global financial crisis that began in 2008.

China's policy of intervening in currency markets to limit the appreciation of its currency against the dollar (and other currencies) and large current account surpluses have made it the world's largest and fastest growing holder of foreign exchange reserves, especially dollar-denominated assets. China has invested a large share of these reserves in U.S. private and public securities, which include long-term (LT) Treasury debt, LT U.S. agency debt, LT U.S. corporate debt, LT U.S. equities, and short-term debt. As of June 2012, China was the second largest holder of U.S. securities (after Japan) at nearly $1.6 trillion (down from $1.7 trillion as of June 2011). U.S. Treasury securities constitute the largest category of China's holdings of U.S. securities—these totaled nearly $1.3 trillion as of June 2013.

China's large holdings of U.S. securities have raised a number of concerns in both China and the United States. For example, in 2009, (then) Chinese Premier Wen Jiabao stated that he was "a little worried" about the "safety" of China's holdings of U.S. debt. The sharp debate in Congress over raising the public debt ceiling in the summer of 2011 and the subsequent downgrade of the U.S. long-term sovereign credit from AAA to AA + by Standard and Poor's in August 2011 appears to have intensified Chinese concerns. In addition, Chinese officials have criticized U.S. fiscal and monetary policies, such as quantitative easing by the U.S. Federal Reserve, arguing that they could lead to higher U.S. inflation and/or a significant weakening of the dollar, which could reduce the value of China's U.S. debt holdings in the future. Some Chinese analysts have urged the government to diversify its reserves away from U.S. dollar assets, while others have called for more rapid appreciation of China's currency, which could lessen the need to hold U.S. assets.

Some U.S. policymakers have expressed concern over the size of China's holdings of U.S. government debt. For example, some contend that China might decide to sell a large share of its U.S. securities holdings, which could induce other foreign investors to sell off their U.S. holdings as well, which in turn could destabilize the U.S. economy. Others argue that China could use its large holdings of U.S. debt as a bargaining chip in its dealing with the United States. Other U.S. policymakers contend that China's holdings of U.S. debt give it little leverage over the United States, because as long as China continues to hold down the value of its currency to the U.S. dollar, it will have few options other than to keep investing in U.S. dollar assets. A Chinese attempt to sell a large portion of its dollar holdings could reduce the value of its remaining dollar holdings, and any subsequent negative shocks to the U.S. (and global) economy could dampen U.S. demand for Chinese exports. They contend that the main issue for U.S. policymakers is not China's large holdings of U.S. securities per se, but rather the high U.S. reliance on foreign capital in general, and whether such borrowing is sustainable. This report examines China's holdings of U.S. securities and its implications on the U.S. economy and U.S.-China relations.

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Because of its low savings rate, the United States borrows to finance the federal budget deficit and its private capital needs. It therefore depends on countries with high savings rates, such as China, to invest some of their capital in the United States. Such investments help to keep U.S. interest rates relatively low and enable the United States to consume more than it produces. According to the International Monetary Fund (IMF), in 2012, the United States was the world's largest importer of foreign capital (at 37.4% of global total), while China was the largest exporter of capital (at 13.3%).[1] From 2002 to 2012, the amount of U.S. public debt that is privately held grew from $3.0 trillion to $9.9 trillion; as a share of GDP, this level rose from 28.4% to 63.2%.[2] Of the U.S. public debt that is privately held, more than half is held by foreigners.[3] Many analysts argue that heavy U.S. reliance on foreign savings is not sustainable and may undermine U.S. economic interests over time.

China's central bank is a major purchaser of U.S. financial assets, largely because of its exchange rate policy.[4] In order to limit the appreciation of China's currency, the renminbi (RMB), against the dollar, China must purchase U.S. dollars. This has led China to amass a huge level of foreign exchange (FX) reserves, which totaled $3.5 trillion at the end of June 2013.[5] Rather than hold dollars (and other foreign currencies), which earn no interest, the Chinese central government has converted some level of its foreign exchange reserve holdings into U.S. financial securities, including U.S. Treasury securities, U.S. agency debt, U.S. corporate debt, and U.S. equities. China's holdings of U.S. public and private securities were estimated by the Federal government to total nearly $1.6 trillion as of June 2012.[6]

U.S. Treasury securities, which are used to finance the federal budget deficit, constitute the largest category of U.S. securities held by China. As of June 2013, these totaled $1.28 trillion. Some U.S. policymakers have expressed concern that China's large holdings of U.S. securities could pose a risk to the U.S. economy, especially if China attempted to divest itself of a large share of its holdings. Others argue that China's large and growing holdings of U.S. securities give it leverage over the United States on economic and noneconomic issues. On the other hand, many analysts contend that, given the current state of the global economy, China has few options for investing its FX holdings, other than to buy U.S. securities. They further argue that any attempt by China to sell off a large share of its current holdings would diminish the value of its remaining holdings and could further destabilize the global economy, which would likely negatively impact China's economy. Hence, it is argued, China's large holdings of U.S. securities give it very little leverage over U.S. policy.

[1] IMF, *Global Financial Stability Report, Old Risks, New Challenges*, April 2013, Statistical Appendix, p.3, at http://www.imf.org/external/pubs/ft/gfsr/2013/01/pdf/statapp.pdf.

[2] U.S. Department of the Treasury, *Treasury Bulletin*, June 2013, at http://www.fms.treas.gov/bulletin/index.html.

[3] Foreign private holders of U.S. public debt include both private investors and government entities. The People's Bank of China, which is controlled by the Chinese government, is the biggest Chinese holder of U.S. public debt.

[4] China contends that its currency policy is intended to promote financial stability in China, while critics contend the main purpose is to keep the value of its currency low in order to benefit Chinese exporters. See, CRS Report RS21625, *China's Currency Policy: An Analysis of the Economic Issues*, by Wayne M. Morrison and Marc Labonte

[5] Bank of China, *Press Release*, July 12, 2013.

[6] The U.S. Department of the Treasury notes that its data on foreign holdings of U.S. securities by country are imperfect, largely because obtaining accurate information on the actual owner of such securities is often difficult to determine, such as when foreign financial intermediaries are involved in custody or management of the securities. Thus, actual Chinese holdings of U.S. securities may be higher than what is reflected in U.S. Department of Treasury

This report examines the importance to the U.S. economy of China's investment in U.S. securities, as well as the policy implications of its holdings for both the United States and China.[7] For the United States, 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 in U.S. securities finance capital investment by firms, household borrowing, and the government budget deficit?[8]

U.S. borrowing from abroad fell by $681 billion in 2009 over the previous year, but then rose by $1,050 billion in 2010, $1,749 billion in 2011, and $821 billion in 2012.[9] According to the U.S. Bureau of Economic Affairs (BEA), U.S. net private savings rose by 108% between 2008 and 2012, although net federal dissaving (i.e., the budget deficit) increased by 75%.[10] Thus, economic imbalances in the United States have become less of an issue of inadequate private saving and more of an issue of high government borrowing since the financial crisis began. It remains to be seen whether the rise in private savings was a permanent shift or a temporary response to the recession, however.[11]

The broader issue for China is whether its current unbalanced economic policies, especially those that have contributed to its large savings rate, over-reliance on exports for its economic growth, and accumulation of huge FX reserves, are sustainable in the long run, especially given economic slowdowns in Europe and the United States. Some have argued that these factors may induce China to accelerate efforts to boost consumer demand and improve domestic living standards, which could include further appreciation of the RMB against the dollar. Such policies could lessen China's need to buy U.S. securities in the future.

China's Foreign Exchange Reserves

China's economic policies, including those that induce high levels of domestic savings and promote export-related activities as the main engine of China's economic growth, have contributed to a surge in China's FX reserves over the past decade, as indicated in **Table 1**. China's exchange rate policies attempt to slow (and sometimes halt) the appreciation of the RMB against the dollar. This makes Chinese exports less expensive and foreign imports into China more expensive than would occur if China maintained a floating currency. The main purpose of this policy is to promote China's export industries and encourage foreign investment. To that end,

[7] China's investments in U.S. securities far exceed its foreign direct investment (FDI) in the United States. FDI data reflect ownership or investment in U.S. businesses (and are not covered by this report). For additional detail on China's FDI flows to the United States, see CRS Report RL33536, *China-U.S. Trade Issues*, by Wayne M. Morrison.

[8] 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.

[9] These data are annual (end-June) changes in foreign holdings of U.S. public and private securities.

[10] U.S. Bureau of Economic Analysis, *National Income and Product Account Tables*. Most of the increase in U.S. net private savings over this period occurred from 2008 to 2009. Although Federal government budget deficits rose sharply between 2008 and 2012, they declined in 2011 and 2012, and are projected by the Congressional Budget Office to fall further in 2013.

[11] The broadest measurement of U.S. savings is gross national savings as a percent of GDP because it reflects the savings of all U.S. public and private entities relative to the size of the economy. U.S. gross savings as a percent of GDP are the lowest among the world's largest economies and have been in relative decline over the past few decades, dropping from 17.3% in 1980 to 8.4% in 2009. This figure rose in each of the next three years, reaching 10.1% in 2012. Source: *Economist Intelligence Unit*.

the Chinese central bank must intervene heavily in currency markets by buying up as many dollars as necessary to meet the government's targeted RMB-dollar exchange rate.[12] Chinese policies that induce high savings rates dampen domestic consumption and demand for imports, while shifting financial resources (i.e., low-cost bank credit) largely to export-oriented industries. As a result, China consumes much less than it produces. Such policies have contributed to China's large annual trade surpluses. The combination of China's large merchandise trade surpluses, inflows of foreign direct investment into China, and inflows of "hot money" into China have been the main components of China's rapid accumulation of FX reserves.[13]

According to Chinese government figures, its FX reserves rose from $212 billion in 2001 to $3,341 billion in 2012, a $3.1 trillion increase and an average annual growth rate of 28.7%.[14] However, from 2011 to 2012, its FX reserves increased by only 4.1%.[15] China's FX reserves as a percent of nominal GDP was 41% in 2012—an unusually high level for a large economy.[16] China's FX reserves as percent of its merchandise imports are significant as well, totaling 184% in 2012.[17]

A listing of the world's top holders of FX reserves at 2012 yearend is shown in **Figure 1**. Not only was China by far the world's largest holder of FX reserves, its reserves were greater than the combined reserves of Japan, Saudi Arabia, Switzerland, Russia, and Taiwan. (Besides Japan, these countries had much smaller economies than China.)

[12] China states that it maintains a managed peg with a number of major currencies, but U.S. officials contend that, in fact, the RMB is pegged largely to the dollar.

[13] "Hot money" refers to inflows of capital from overseas investors who attempt to bypass Chinese government capital restrictions. Some attempt to purchase Chinese currency in the belief that the Chinese government will continue to appreciate the RMB in the near future, while others are seeking to invest in certain "high growth" sectors, such as real estate. The inflows of hot money force the government to intervene to buy the inflows of foreign currency, such as the dollar, to maintain its exchange rate targets.

[14] Some analysts contend that China's actual FX reserves are much higher than official Chinese data. For example, Brad Setser and Arpana Pandey contend that China's official data on FX reserves do not include holdings and assets held by China's main sovereign wealth fund, China Investment Corporation (CIC), and those held by state banks. They estimated that China's actual FX holdings were 18% higher than its official estimates. See Council on Foreign Relations, *China's $1.7 Trillion Bet: China's External Portfolio and Dollar Reserves*, by Brad Setser and Arpana Pandey, January 2009.

[15] According to the People's Bank of China, FX reserves grew to $3.5 trillion as of June 2013. These were 9.4% higher than June 2012 levels.

[16] For example, other major economies with large FX reserves had much smaller levels, including India (14.7%), Brazil (16.4%), Japan (20.6%), and Russia (24.0%).

[17] For India, Brazil, Japan, and Russia, this value was 52.2%, 158.9%, 138.5%, and 153.6%, respectively.

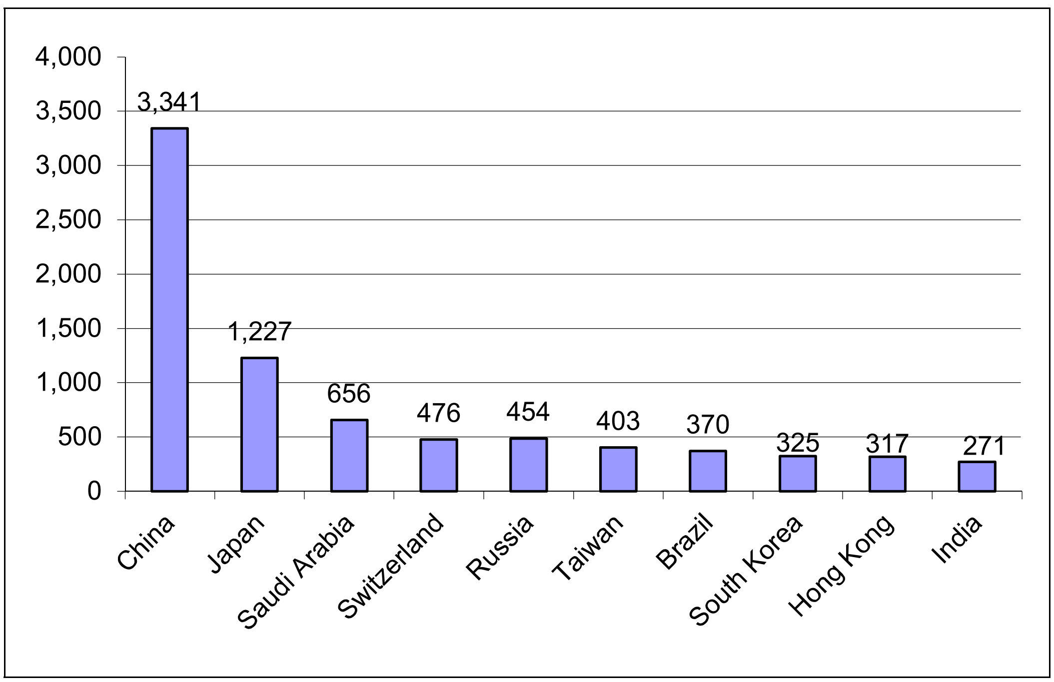
Table 1. China's Foreign Exchange Reserves: Totals and as a % of GDP, 2001-2012

Year	Billions of U.S. Dollars	As a % of Chinese GDP	As a % of Merchandise Imports
2001	212.2	16.3	86.9
2002	286.4	20.0	96.9
2003	403.3	24.6	97.6
2004	609.9	31.6	108.7
2005	818.9	36.5	124.1
2006	1,068.5	40.2	135.0
2007	1,528.2	45.2	160.0
2008	1,946.0	45.0	171.9
2009	2,399.2	48.1	238.9
2010	2,847.3	48.4	204.2
2011	3,181.1	44.1	182.7
2012	3,341.0	40.6	183.9

Source: Global Insight, Economist Intelligence Unit, and the Chinese State Administration of Foreign Exchange.

Figure 1. Major Holders of Foreign Exchange Reserves in 2012 Yearend

($ billions)



Source: Economist Intelligence Unit.

China's Holdings of U.S. Public and Private Securities[18]

Although the Chinese government does not make public the dollar composition of its FX holdings, some analysts estimate this level to be around 70%.[19] U.S. assets have generally been favored by China for its investment needs for a number of reasons. First, in order to maintain the exchange rate effects that lay behind the acquisition of U.S. dollars, those dollars must be invested in dollar-denominated securities. Second, the United States is the world's largest economy and has the biggest capital market. In 2011(the most recent year available), the combined value of U.S. private and public debt securities was $33.7 trillion (compared with $15.4 trillion for Japan and $5.3 trillion for Germany) and accounted for 34.2% of global debt securities.[20] Many analysts contend that the U.S. debt securities market is the only global market that is big enough to absorb a big part of China's large and growing FX holdings. U.S. securities have also been favored by China because, historically, they have been considered to be safe and liquid (i.e., easily sold) relative to other types of investments.[21] Finally, U.S. Treasury securities are backed by the full faith and credit of the U.S. government, which guarantees that interest and principal payments will be paid on time. The global economic slowdown and the European sovereign debt crisis may have also boosted the attractiveness of U.S. securities for China.[22] According to China's State Administration of Foreign Exchange (SAFE), its main principles for administrating China's FX reserves are "security, liquidity, and increases in value, among which security is the primary principle."[23] In recent years, China has sought to use some of its FX reserves to acquire overseas assets (such as foreign companies). From 2006 to 2012, China's annual outflows of foreign direct investment rose from $26.5 billion to $84.2 billion.

U.S. financial securities consist of a mix of securities issued by the U.S. government and private sector entities and include long-term (LT) U.S. Treasury securities (which are discussed in more detail in the next section), LT U.S. government agency securities,[24] LT corporate securities (some of which are asset-backed), equities (such as stocks), and short-term debt. LT securities are those with no stated maturity date (such as equities) or with an original term to maturity date of more

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

[19] 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 FX reserves at 70%.

[20] IMF, *Global Financial Stability Report*, Old Risks, New Challenges, April 2013, Statistical Appendix, p.11, at http://www.imf.org/external/pubs/ft/gfsr/2013/01/pdf/statapp.pdf.

[21] See CRS Report RL34582, *The Depreciating Dollar: Economic Effects and Policy Response*, by Craig K. Elwell.

[22] The global financial crisis, global economic slowdown, and public debt crisis in many countries have induced capital to flow to the United States, often referred to as a "flight to quality." This has pushed yields on U.S. Treasury securities to record lows. For August 15, 2013, the yields on one-year, five-year, and ten-year Treasury nominal constant maturities were 0.13%, 1.54%, and 2.77%, respectively. In comparison, the yields for the same securities on August 15, 2007, were 4.41%, 4.41%, and 4.69%, respectively. Source: Department of the Treasury, *Resource Center, Daily Treasury Yield Curve Rates*.

[23] See China's State Administration of Foreign Exchange (SAFE), *FAQs on Foreign Exchange Reserves*, July 20, 2010.

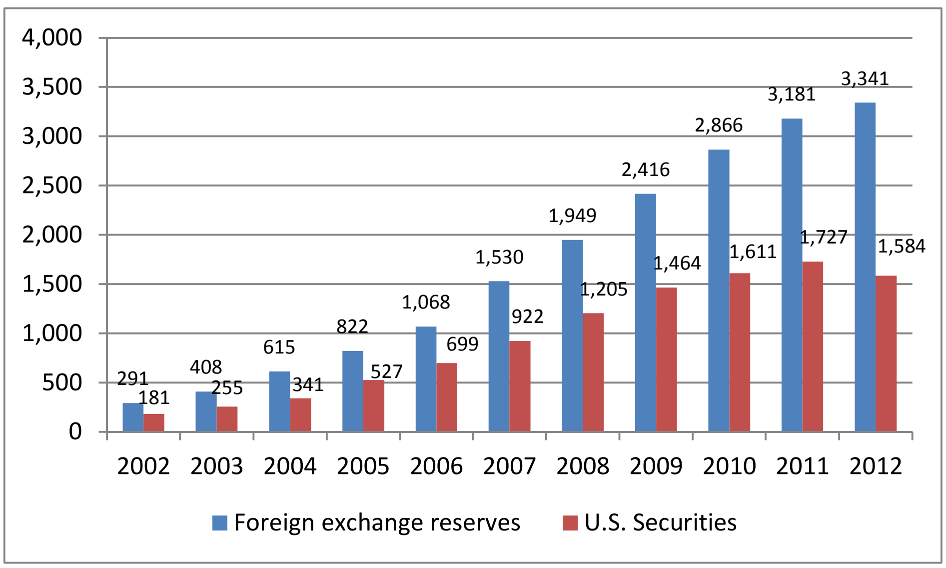
[24] Agency securities include both federal agencies and government-sponsored enterprises created by Congress (e.g., Fannie Mae and Freddie Mac) to provide credit to key sectors of the economy. Some of these securities are backed by assets (such as home mortgages).

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. The Department of the Treasury issues 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.[25]

The latest Treasury survey of portfolio holdings of U.S. securities was issued on April 30, 2013.[26] From June 2002 to June 2011, China's purchases of U.S. Treasury securities increased more rapidly than that any other country, rising from $181 billion to $1.73 trillion. In June 2009, China overtook Japan as the largest holder of U.S. securities, and China remained the largest holder through June 2011. As indicated in **Figure 2**, as China's FX reserves have risen, so have its holdings of U.S. securities. However, China's holdings of U.S. securities decreased by $143 billion from June 2011 to June 2012– the only time in the last ten years that its holdings dropped. As a result, China's ranking as a holder dropped to second after Japan[27] A decrease in China's holdings of U.S. Treasury securities (discussed below) was the main cause of the drop in China's overall holdings of U.S. securities.

Figure 2. China's Foreign Exchange Reserves and Holdings of U.S. Public and Private Securities: 2002-2012

($ billions)



Sources: U.S. Treasury Department, *Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2012*, April 2013.

Note: Data on foreign exchange reserves are end of year values while data on holdings of U.S. securities are through the end of June.

[25] The report is prepared jointly by the Department of the Treasury, the Federal Reserve Bank of New York, and the Board of Governors of the Federal Reserve System.

[26] Department of the Treasury, Federal Reserve Bank of New York, and Board of Governors of the Federal Reserve System*, Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2012, April 2013,* available athttp://www.treasury.gov/resource-center/data-chart-center/tic/Documents/shla2012r.pdf.

[27] Data on China's holdings of U.S. securities exclude holdings by Hong Kong and Macao. These entities, though part of China, are reported separately by Treasury.

Table 2 lists the top three holders of U.S. securities as of June 2012, broken down by the type of securities held, and **Figure 3** provides a breakdown of China's holdings of U.S. securities by category. These data indicate that as of June 2012:

- China accounted for 12.0% of total foreign-held U.S. securities (compared with 4.1% in 2002). However, this was down from 13.9% in June 2011.
- LT Treasury securities constituted the bulk of China's holdings of U.S. securities (at 71.5% of total), followed by equities (13.9%) and LT agency debt (12.7%).[28]
- China was the largest foreign holder of LT Treasury debt at 24.4% of total (down from 32.2% in June 2011).
- China was the second-largest holder of U.S. agency debt (20.4% of total) after Japan.[29]
- China was the ninth-largest holder of U.S. equities at $221 billion, which was 5.2% of total foreign holdings.

Table 2. Top Five Foreign Holders of U.S. Securities and China's Share of These Holdings by Category as of June 2012

($ billions)

	Total	LT Treasury	LT Agency	LT Corporate	Equities	Short Term Debt
Japan	1,835	1,048	249	162	314	63
China	1,592	1,138	202	22	221	9
Cayman Islands	1,031	57	36	338	516	83
United Kingdom	1,008	111	12	368	495	22
Luxembourg	837	97	26	351	292	72
Foreign Total	13,261	4,673	991	2,549	4,247	811
China's June 2012 Holdings as a Percent of Total Foreign Holdings	12.0%	24.4%	20.4%	0.9%	5.2%	1.1%

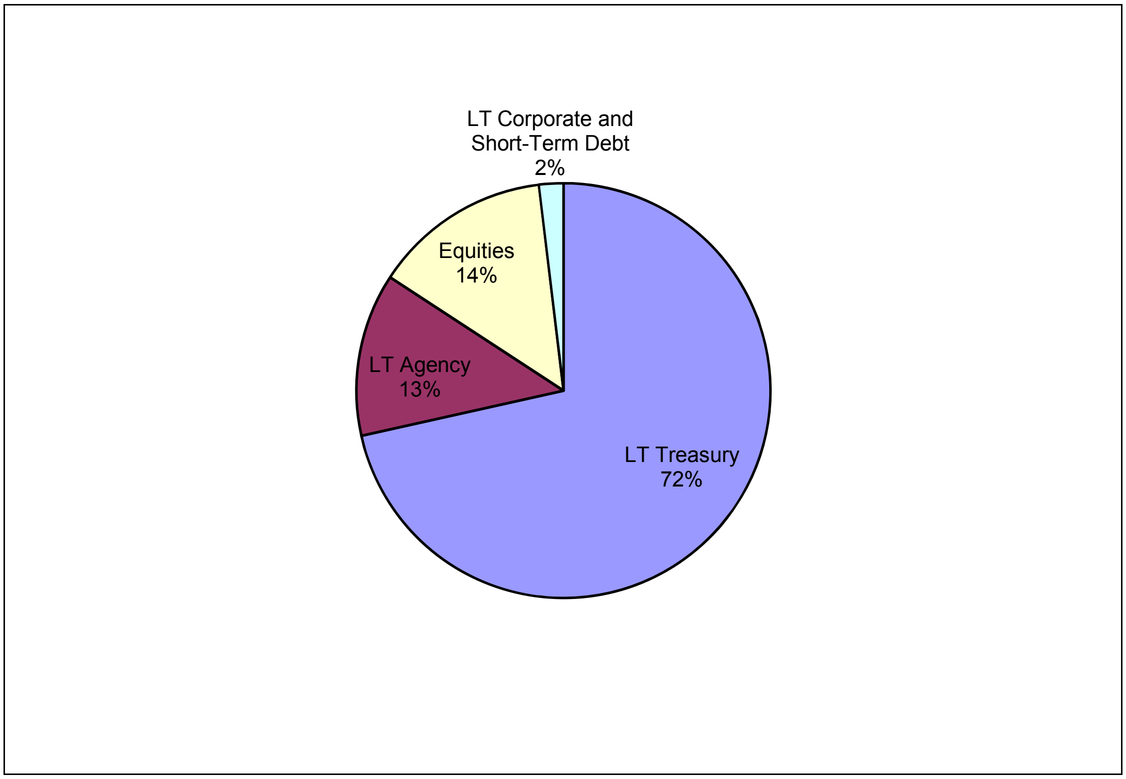
Source: U.S. Department of the Treasury, *Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2012*, April 2013.

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. Data on China exclude Hong Kong and Macau.

[28] In June 2008, China's holdings of LT U.S. Agency debt constituted 43.7% of its holding of U.S. securities, which were greater than its holdings of LT U.S. Treasury securities (43.3%). However, the bursting of the U.S. housing bubble and the subsequent federal takeover of Freddie Mac and Fannie Mae in 2008 led China to significantly reduce its holdings of U.S. Agency debt, while increasing its holdings of other securities, especially Treasury securities.

[29] China was the largest holder of Agency LT debt in June 2010 at 33.2% of total.

Figure 3. China's Holdings of U.S. Securities by Major Category as a Percent of Total Holdings as of June 2012



Source: U.S. Department of the Treasury, *Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2012*, April 2013.

China's Ownership of U.S. Treasury Securities[30]

U.S. Treasury securities are the largest category of U.S. securities and are the main vehicle the U.S. government uses to finance the federal debt. These data are reported on a monthly basis. As of June 2013, foreign holdings of U.S. Treasury securities totaled $5.6 trillion. As indicated in **Table 3**, China's holdings of U.S. Treasury securities increased rapidly from 2003 to 2010, both in dollar terms (up nearly $1 trillion) and as a percent of total foreign holdings (from 10.4% to 26.1%).[31] In September 2008, China overtook Japan to become the largest foreign holder of U.S. Treasury securities (it was seventh largest in 1997) and has remained the largest through June 2013.[32] China's holdings of Treasury securities fell by $8.2 billion in 2011, but rose by $68.5 billion in 2012. China's holdings as of June 2013 (at $1,256 billion) were $122.8 billion higher than June 2012 levels (see **Figure 4**). China's share of total foreign holdings fell from 26.1% in 2010 to 23.0% in 2011 and to 21.9% in 2012, but rose to 22.8% as of June 2013. A listing of the top five foreign holders of U.S. Treasury securities as of June 2013 is shown in **Table 4**.

[30] For a general discussion of foreign ownership of U.S. debt, see CRS Report RS22331, *Foreign Holdings of Federal Debt*, by Marc Labonte and Jared C. Nagel. For a discussion on Treasury's debt management practices, see CRS Report R40767, *How Treasury Issues Debt*, by Mindy R. Levit.

[31] During this period, China accounted for 34% of net new foreign holdings of U.S. Treasury securities.

[32] Data on China's holdings of U.S. Treasury securities exclude Hong Kong and Macau.

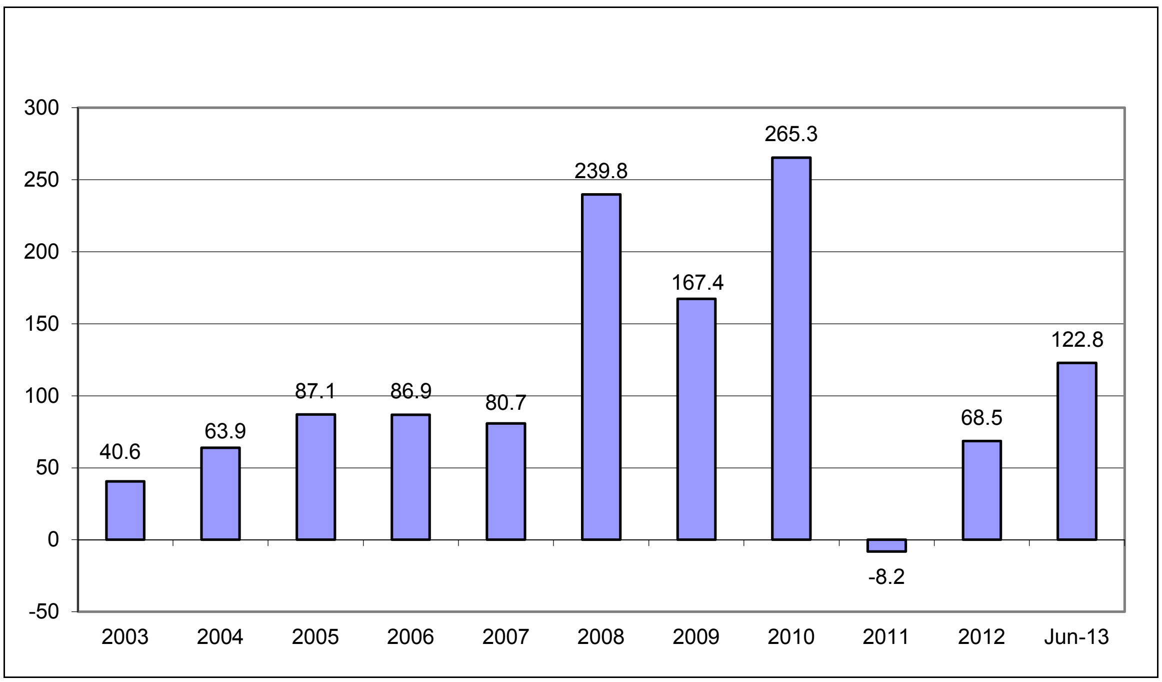
Table 3. China's Year-End Holdings of U.S. Treasury Securities: 2003-2012 and as of June 2013

($ billions and as a percent of total foreign holdings)

	2003	2005	2007	2009	2010	2011	2012	May 2013
China's Holdings ($billions)	159.0	310.0	477.6	894.8	1,160.1	1,151.9	1,220.4	1,275,8
Holdings as a % of Total Foreign Holdings	10.4%	15.2%	20.3%	24.2%	26.1%	23.0%	21.9%	22.8%

Source: Department of Treasury, Major Foreign Holders of Treasury Securities Holdings, August 15, 2013.

Figure 4. Annual Change in China's Holdings of U.S. Treasury Securities: 2002-2012 and June 2012-June 2013 ($ billions)



Source: U.S. Department of the Treasury.

Note: Data for June 2013 are year-on-year.

Table 4. Top 5 Foreign Holders of U.S. Treasury Securities as of June 2013

	Total Foreign Holdings ($ billions)	Country Holdings as a Share of Total Foreign Holdings (%)
China	1,275.8	22.8
Japan	1,083.4	19.3
Caribbean Banking Centers	290.8	5.2
Oil Exporters	256.8	4.6
Brazil	253.7	4.5
Total Foreign Holdings	5,600.6	100.0

Source: Department of Treasury, *Major Foreign Holders of Treasury Securities Holdings*, August 15, 2013.

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

The growing U.S. dependency on China to purchase U.S. Treasury securities to help fund the U.S. budget deficit has become a major concern to many U.S. policymakers. Some have raised concerns that China's large holdings may give it leverage over the United States on economic as well as noneconomic issues. Others have expressed concern that China might lose faith in the ability of the United States to meet its debt obligations, and, thus, might seek to liquidate such assets or significantly cut back on purchases of new securities, a move some contend could damage the U.S. economy. Still others contend that China's purchases of U.S. securities were a major contributing factor to the U.S. sub-prime mortgage crisis and subsequent global economic slowdown because such purchases helped to keep real U.S. interest rates very low and increased global imbalances. Some warn that similar bubbles could occur in the future if imbalances between the United States and China are not addressed.[33] Chinese officials, on the other hand, have expressed concerns over the safety of their large holdings of U.S. debt, and some have argued that China should either diversify away from U.S. Treasury securities or implement policies that slow the accumulation of FX reserves, which would lessen the need to buy U.S. assets.

Growing Bilateral Tensions over the U.S. Public Debt

Since the beginning of the global financial crisis in 2008, U.S. government officials have increasingly sought to offer assurances to Chinese officials regarding the safety of China's holdings of U.S. government debt securities and to encourage China to continue to purchase U.S. securities. For example, during her first visit to China on February 21, 2009, (then) Secretary of State Hillary Rodham Clinton was quoted as saying 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.[34] However on March 13, 2009, (then) Chinese Premier

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[33] Low U.S. interest rates sharply contributed to U.S. demand for housing. Homeowners viewed growing home values as a source of income to draw from through home equities, which were used to buy consumer goods. The rise in U.S. domestic consumption boosted foreign imports, such as from China, which sharply increased the U.S. trade deficit.

[34] ABC News International, "Clinton Seeks to Reassure China on T-Bills," February 21, 2009.

Wen Jiabao at a news conference stated: "We've lent a huge amount of capital 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. I would like to call on the United States to honor its words, stay a credible nation and ensure the safety of Chinese assets."[35] On March 24, 2009, the governor of the People's Bank of China, Zhou Xiaochuan, published a paper calling for replacing the U.S. dollar as the international reserve currency with a new global system controlled by the IMF.[36]

The recent contentious U.S. debates in Congress over raising the debt ceiling and over how to address long-term U.S. debt issues, along with the downgrade of the long-term sovereign credit rating of the United States from AAA to AA + by Standard and Poor's in August 2011, appear to have intensified China's concerns over its U.S. debt holdings.[37] Several government-controlled Chinese newspapers issued sharp criticism of U.S. economic policies (as well as the U.S. political system). For example:

- A July 28, 2011, Xinhua News Agency (Xinhua) editorial stated: "With its debt approximating its annual economic output, it is time for Washington to revisit the time-tested common sense that one should live within one's means."
- An August 3, 2011, a Xinhua editorial stated: "Should Washington continue turning a blind eye to its runaway debt addiction, its already tarnished credibility will lose more luster, which might eventually detonate the debt bomb and jeopardize the well-being of hundreds of millions of families within and beyond the U.S. borders."
- A Xinhua August 6, 2011, editorial said: "The U.S. government has to come to terms with the painful fact that the good old days when it could just borrow its way out of messes of its own making are finally gone. International supervision over the issue of U.S. dollars should be introduced and a new, stable and secured global reserve currency may also be an option to avert a catastrophe caused by any single country."
- A Xinhua editorial on August 8, 2011, stated: "The days when the debt-ridden Uncle Sam could leisurely squander unlimited overseas borrowing appeared to be numbered as its triple A-credit rating was slashed by Standard & Poor's (S&P) for the first time on Friday. China, the largest creditor of the world's sole superpower, has every right now to demand the United States to address its structural debt problems and ensure the safety of China's dollar assets."

The U.S. debt issue was a major topic during Vice President Joe Biden's trip to China in August 2011. At a meeting with Chinese Premier Wen Jiabao on August 19, 2011, Vice President Biden stated that "we appreciate and welcome your concluding that the United States is such a safe haven because we appreciate your investment in U.S. treasuries. And very sincerely, I want to make clear that you have nothing to worry about in terms of their—their viability."[38] In a speech at Sichuan University, he stated that "the concern that we will not make good on the investments

[35] *China Daily*, March 14, 2009, http://www.chinadaily.com.cn/china/2009-03/14/content_7578931.htm.

[36] *Financial Times*, "China Calls for New Reserve Currency," March 24, 2009.

[37] Failure to extend the debt ceiling could have put the U.S. government in default of its debt obligations.

[38] The White House, Office of the Vice President, *Remarks by Vice President Biden at a Meeting with Chinese Premier Wen*, August 19, 2011, available at http://www.whitehouse.gov/the-press-office/2011/08/19/remarks-vice-president-biden-meeting-chinese-premier-wen.

that people have made—in your case up to $1.7 trillion total out of a very large economy is not to worry about. We could not afford—we could not afford not to make good on that requirement."[39]

Some analysts contend that China's main concern is not a possible U.S. default on its debt, but rather U.S. monetary policies that have been utilized by the Federal Reserve in recent years to stimulate the economy, namely the purchases of U.S. Treasury securities, agency debt, and agency mortgage-backed securities. Such measures, often referred to as "quantitative easing" (QE), have led the Federal Reserve to purchase over $2 trillion in U.S. securities since March 2009 in an effort to lower long-term interest rates.[40] An August 25, 2011, editorial in *China Daily* stated that "China is not worried that Standard & Poor's has downgraded the U.S. credit rating from AAA to AA+. Rather it is concerned about the Fed announcing QE3. If the U.S. administration chooses to make the irresponsible choice of devaluating the dollar further, China would not only stop buying U.S. debt, but also gradually decrease its holdings, which would certainly not be in the interests of the U.S. or in accordance with Biden's wishes."[41] Chinese officials have expressed concerns that actions by the Federal Reserve to boost the U.S. money supply will undermine the value of China's holdings of U.S. dollar assets, either by causing the dollar to depreciate against other major currencies or by significantly increasing U.S. inflation. To date, quantitative easing has not led to a noticeable increase in U.S. inflation, and the Federal Reserve has argued that it has sufficient tools to maintain low inflation in the future.

Do China's Holdings of U.S. Debt Give it Leverage?

It is difficult to determine whether China's holdings of U.S. securities give it any leverage over U.S. policies.[42] The importance of China's debt holdings to the U.S. economy can be measured in a number of different ways (see text box below). During his confirmation hearing to become U.S. Ambassador to China before the Senate Foreign Relations Committee in May 2011, Gary Locke, in response to a question on this issue, stated that China's holdings of U.S. Treasury securities did not "in any way influence U.S. foreign policy."[43]

[39] The White House, Office of the Vice President, *Remarks by Vice President Biden,* on *U.S.-China Relations followed by Q&A with Students, Sichuan University, Chengdu, China, August 21, 2011.*

[40] CRS Report R41540, *Quantitative Easing and the Growth in the Federal Reserve's Balance Sheet*, by Marc Labonte.

[41] *China Daily*, "Dilemma of Yuan revaluation," August 25, 2011, available at http://www.chinadaily.com.cn/opinion/2011-08/25/content_13185617.htm.

[42] China has attempted to use the U.S. debt crisis to criticize U.S. economic policies and its political system, implying that Chinese economic and political policies are more stable.

[43] *Congressional Quarterly*, Congressional Transcripts, Senate Committee on Foreign Relations, *Hearing on the Nomination of Secretary of Commerce Gary Locke to Be Ambassador to People's Republic of China*, May 26, 2011.

Indicators of the Size of China's Ownership of U.S. Public Debt

China's ownership of U.S. Treasury securities, or U.S. federal debt, is significant, but the relative importance of those holdings to the overall U.S. federal debt can be measured in different ways. The U.S. public debt totaled $16.4 trillion at the end of 2012. Of this amount, 40% was held by U.S. government trust funds and 60% was privately held. Of the total level of privately held U.S. Treasury securities ($9.9 trillion), foreigners owned 56% of the total ($5.7 trillion).[44] China's holdings of U.S. Treasury securities as of December 2012 were $1.2 trillion. The importance of China's holdings of U.S. debt securities (as of December 2012) can be measured as follows. They constituted: 21.9% of total foreign holdings of U.S. Treasury securities, 12.3% of U.S. privately-held Treasury securities, and 7.4% of the total level of U.S. federal debt (privately held and intergovernmental).

The amount of interest payments the U.S. government makes to China each year is not precisely known since a breakdown of the types of Treasury securities, their maturity dates, and their yields is not published.[45] A rough estimate can be made by taking the Treasury Department's data on interest paid on the debt held by foreigners in FY2012 ($93 billion) and multiplying it by China's holdings of U.S. Treasury securities as percent of total foreign holdings. Based on these data, it is estimated that U.S. interest rate payments to China on its holdings of U.S. Treasury securities in FY2012 were $113.4 million.[46]

China's holdings of U.S. Treasury debt at the end of 2012 were roughly equal to $3,887 for every American and $918 for every Chinese. According to one observer: "Never before has a country as poor as China provided so much financing to a country as rich as the United States."[47]

Some Chinese officials in the past have suggested that its holdings of U.S. debt could be used in regard to economic and political disputes with the United States. To illustrate, an August 7, 2007, article in the *Telegraph* (an online British newspaper) cited interviews with officials from two leading Chinese government think tanks who reportedly stated that China had the power to make the dollar collapse (if it chose to do so) by liquidating large portions of its U.S. Treasury securities holdings if the United States imposed trade sanctions to force an appreciation of the RMB, and that the threat to do so could be used as a "bargaining chip." Ding Gang, a senior editor with China's *People's Daily*, wrote in an editorial in August 2011 that China should directly link the amount of U.S. Treasury holdings with U.S. arms sales to Taiwan, stating that "now is the time for China to use its 'financial weapon' to teach the United States a lesson if it moves forward with a plan to sale arms to Taiwan. In fact, China has never wanted to use its holdings of U.S. debt as a weapon. It is the United States that is forcing it to do so ... to defend itself when facing threats to China's sovereignty."[48]

The likelihood that China would suddenly reduce its holdings of U.S. securities is questionable because doing so could have a significant negative impact on the Chinese economy. 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.[49] This would also occur if the value of the dollar

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

[45] For example, Treasury securities maturity dates range from one month to 30 years. Yields change on a daily basis.

[46] For an overview of the types of securities issue by Treasury and its management of U.S. debt, see CRS Report R40767, *How Treasury Issues Debt*, by Mindy R. Levit.

[47] Council on Foreign Relations, "China's $1.7 Trillion Bet: China's External Portfolio and Dollar Reserves," by Brad Setser and Arpana Pandey, January 2009.

[48] *People's Daily*, "China must punish US for Taiwan arm sales with 'financial weapon'", August 8, 2011, at http://english.people.com.cn/90780/91342/7562776.html.

[49] 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.

were greatly diminished in international currency markets due to China's sell-off.[50] Second, such a move would diminish U.S. demand for Chinese imports, either through a rise in the value of the RMB 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).[51] U.S. imports from China in 2012 were $426 billion (about one-fifth of China's total exports). A sharp reduction of U.S. imports from China could have a significant impact on China's economy, which heavily depends on exports for economic growth and employment (A growing economy is viewed by the Chinese government as a vital source of political stability).[52] 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. One analyst described the financial interdependency between the United States and China as "a kind of balance of financial terror." According to Derek Scissors, a Research Fellow with the Heritage Foundation:

> One area of concern in the U.S. is Chinese financial influence. As noted, Chinese investment is largely involuntary, a function of having a great deal of money and no place else to put it. This refines the usual analogy of banker and customer to one where the banker has a choice of "lending" to one particular customer for the better part of her business, or crafting an exceptionally large mattress. The influence is mutual." Who needs the other more varies with American and international financial conditions. The more money the U.S. borrows, the more the American economy needs the PRC. The more desirable Treasury bonds are, the more China needs us. The U.S. is planning to run a federal deficit of over $1 trillion but there has been a flight to quality and American Treasury bonds are highly desired. There is balance on this score. The PRC can exercise little or no leverage over American policy by virtue of its purchase of our bonds.

However, Scissors goes on to state:

> There is future danger in the possibility that we will run sustained, gigantic deficits. The longer these last, the more likely it is that U.S. treasuries will become relatively less attractive, thereby tipping the balance of influence toward China. The U.S. could come to need Chinese purchases more than the PRC needs American bonds, yet another argument to control the federal budget.[53]

Many analysts contend that the U.S. debt securities market is the only global market that is big enough to absorb a big part of China's large and growing FX holdings. Economic problems in Japan and Europe do not leave China with many alternatives for investing its massive FX reserves. According to Andrew Peaple, a writer for the *Wall Street Journal*: "Some say China could switch holdings into gold—but that market's highly volatile, and not large enough to absorb

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

[51] 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.

[52] 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).

[53] The Heritage Foundation, Testimony before the U.S.-China Economic and Security Review Commission on China's Role in the Origins of and Responses to the Global Recession, by Derek Scissors, Ph.D., March 3, 2009, available at http://www.heritage.org/Research/Testimony/Testimony-before-the-US-China-Economic-and-Security-Review-Commission-on-Chinas-Role-in-the-Origins-of-and-Responses-to-the-Global-Recession.

more than a small proportion of China's reserves. It's not clear, meanwhile, that euro, or yen-denominated debt is any safer, more liquid, or profitable than U.S. debt—key criteria for China's leadership."[54]

Legislation was introduced in the 112th Congress that would have sought to assess the implications for the United States of China's ownership of U.S. debt.

- H.R. 2166 (Sam Johnson) and S. 1028 (Cornyn), both titled "Foreign-Held Debt Transparency and Threat Assessment Act," would seek to increase the transparency of foreign ownership of U.S. debt instruments, especially in regard to China, in order to better assess the potential risks such holdings could pose for the United States. The bills state, for example, that under certain circumstances, China's holdings of U.S. debt could give it a tool with which it can try to manipulate U.S. domestic and foreign policymaking, including the U.S. relationship with Taiwan; and that China could attempt to destabilize the U.S. economy by rapidly divesting large portions of its holdings of U.S. debt instruments. The bills would require the President to issue a quarterly report on foreign holders of U.S. debt instruments, which would include a breakdown of foreign ownership by country of domicile and by the type of creditor (i.e., public, quasi-public, private); an analysis of the country's purpose and long-term intentions in regard to its U.S. debt holdings; an analysis of the current and foreseeable risks to U.S. national security and economic stability of each nation's U.S. debt holdings; and a determination whether such risks are "acceptable or unacceptable." If the President determined that a foreign country's holdings of U.S. debt instruments were an unacceptable risk, he would be required to formulate an action plan to reduce that risk.
- The conference report accompanying the National Defense Authorization Act of FY2012 (H.R. 1540, P.L. 112-81) included a provision requiring the Secretary of Defense to conduct a national security risk assessment of U.S. federal debt held by China. The Secretary of Defense issued a report in July 2012, stating that "attempting to use U.S. Treasury securities as a coercive tool would have limited effect and likely would do more harm to China than to the United States. As the threat is not credible and the effect would be limited even if carried out, it does not offer China deterrence options, whether in the diplomatic, military, or economic realms, and this would remain true both in peacetime and in scenarios of crisis or war."

[54] *Wall Street Journal*, "China's Limited Options on Treasurys," March 16, 2009, available at http://online.wsj.com/article/SB123694305633018403.html?mod=googlenews_wsj.

What If China Reduces its Holdings of U.S. Securities?[55]

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. What might happen if China no longer purchased U.S. securities and/or tried to sell a significant share of its dollar holdings?

If China stopped buying U.S. securities, the United States would need other investors (foreign and domestic) to fill in the gap. Such investors would presumably require higher interest rates than those prevailing today to be enticed to buy them. One economist in 2007 estimated that a Chinese move away from long-term U.S. securities could raise U.S. interest rates by as much as 50 basis points.[56] Higher interest rates would 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.[57] 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 large size of U.S. financial markets.

Since China held about $1.6 trillion of U.S. private and public securities (largely U.S. Treasury securities) as of June 2012, 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 was gradual or sudden.[58] 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.

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[55] 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.

[56] Testimony of Brad Setser before the House Budget Committee, *Foreign Holdings of U.S. Debt: Is our Economy 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.

[57] 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.

[58] China's reduction in its holdings of U.S. securities (including Treasury securities) from June 2011 to June 2012 did not appear to generate much concern in global markets and other foreign investors were willing to increase their Treasury holdings.

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.[59] (Empirical evidence suggests that the full effects of a change in the exchange rate on traded goods take 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.)[60] 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, causing prices on the stock market to fall, undermining efficient financial intermediation, and jeopardizing the solvency of various debtors and creditors. Resources may not be able to shift quickly enough from interest-sensitive sectors to 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. In March 2007, Federal Reserve Chairman Ben Bernanke reportedly stated in a letter to Senator Shelby that "because foreign holdings of U.S. Treasury securities represent only a small part of total U.S. credit market debt outstanding, U.S. credit markets should be able to absorb without great difficulty any shift of foreign allocations."[61]

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 in 2008, 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 experienced in U.S. financial markets over the past few years 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 current account deficit by China or other countries, it is hard to imagine what would.

[59] 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.

[60] 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.

[61] Reuters, "Bernanke-China Holdings of US Debt Not Problematic," March 26, 2007.

China's Holdings of U.S. Securities in the Context of Global Imbalances

Many economists argue that concerns over China's holdings of U.S. securities represent part of a broader problem related to "global imbalances" – the concept that large differences in saving and investment between countries have manifested itself in large trade imbalances. For the U.S. economy, this issue is manifested namely in its low savings rate and thus its dependence on foreign saving to finance its investment needs and federal budget deficits. The large U.S. current account deficit (the 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. The U.S. current account deficit as a percent of GDP fell from a peak of 6.0% in 2006 to 2.7% in 2009 (largely due to the effects of the global economic slowdown). It rose to 3.0% in 2010 and has remained around that level through 2012. The International Monetary Fund (IMF) projects that this figure will fall to 2.9% in 2013, but then will rise over the next five years, reaching 3.5% by 2018 (still significantly below its historical peak).[62] In that light, a move by China to a more flexible currency and capital control policy would reduce the Chinese government's need to purchase U.S. securities (notably, Treasury securities), but could result in greater private Chinese investment in U.S. securities (notably, private securities).

Some economists warn 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 could result in higher interest rates and lower investment rates, all else equal, which could reduce long-term growth.[63] A reliance on foreign governments such as China, to finance the U.S. current account deficit (which includes the U.S. merchandise trade deficit) by increasing their foreign exchange reserves may prolong the necessary adjustment process. Thus, it is argued, the United States must boost its level of savings in the long run in order to reduce its vulnerability to a potential shift away from U.S. assets by foreign investors. It remains to be seen whether this adjustment process began in the United States in 2008, or whether the rise in private saving and decline in the current account deficit was only a temporary response to the recession. Some 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.[64]

Some economists view China's purchases of U.S. securities as a type of subsidy that is transferred from Chinese savers to U.S. consumers and borrowers in the form of lower-cost Chinese products and lower U.S. interest rates. That subsidy helps to boost U.S. consumption of Chinese products, which supports China's export industries. However, the subsidy is at the expense of Chinese consumers and non-export industries, largely because China's undervalued RMB makes imports

[62] IMF, *World Economic Database*, April 2013 edition.

[63] See CRS Report RL33186, *Is the U.S. Current Account Deficit Sustainable?*, by Marc Labonte.

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

more expensive than they would be if the RMB were a floating currency.[65] The lack of a social safety net forces Chinese workers to save a significant part of their income. That savings is indirectly used to finance the Chinese government's purchases of U.S. securities.

Chinese purchases and holdings of U.S. securities have reportedly been controversial in China, according to some media reports, many of which cite complaints among some Chinese Internet bloggers over low returns on Chinese investment of its FX reserves. Many analysts (including some in China) have questioned the wisdom of China's policy of investing a large level of FX reserves in U.S. government securities, which offer a relatively low rate of return, when China has such huge development needs at home. One Chinese blogger reportedly wrote: "Chinese people are working so hard, day in and day out, the economic environment is so good, but people's livelihoods are not so great — turns out it is because the government is tightening people's waist belts to lend money to the United States."[66] Some Chinese analysts have argued that the debt problems in Europe and the United States will decrease their demand for Chinese products, and that a depreciating dollar will lower the value of Chinese dollar assets. Thus, they argue, China will need to accelerate its economic reforms in order to boost domestic consumption (including increased imports), lower its dependency on exporting for economic growth, and slow or reduce China's FX reserves and holdings of U.S. securities.

China's contribution to global imbalances comes through its high saving rate and current account surplus. 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 U.S. interest rates would be expected to rise.

Author Contact Information

Wayne M. Morrison
Specialist in Asian Trade and Finance
wmorrison@crs.loc.gov, 7-7767

Marc Labonte
Specialist in Macroeconomic Policy
mlabonte@crs.loc.gov, 7-0640

[65] For additional information on this issue, see CRS Report RS21625, *China's Currency Policy: An Analysis of the Economic Issues*, by Wayne M. Morrison and Marc Labonte.

[66] *New York Times*, "Chinese Fault Beijing Over Foreign Reserves," August 9, 2011, available at http://www.nytimes.com/2011/08/09/business/global/chinese-fault-beijings-moves-on-foreign-reserves.html