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Analysis: What is Plan B if China dumps its U.S. debt?

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By Emily Flitter

NEW YORK (Reuters) - When borrowing money it's always good to have a Plan B in case a big creditor pulls the plug. That should be true whether the sum is a few thousand dollars or about a trillion, the size of the United States government's debt to China.

With Chinese President Hu Jintao due to arrive in Washington on Tuesday, it is worth asking about U.S. officials' Plan B just in case one day relations take a surprise turn for the worse and Beijing dumps its holdings of U.S. treasuries.

China is officially the United States' biggest foreign creditor, with roughly $900 billion in Treasury holdings -- or over $1 trillion with Hong Kong's holdings included.

That means it could do severe damage to U.S. debt markets if it suddenly started selling large amounts.

Most experts say if there were signs of this happening, the U.S. government would go for a combination of persuading Americans to buy more U.S. debt, the same way they did in World War II, and finding friendly foreign governments to make additional purchases.

Banks could be called on to increase their holdings of treasuries, and as a last resort, the Federal Reserve could also be called on to fill the gap, though this could risk turning any dollar weakness into a slump.

"The U.S. government should have and maybe still could call on the people of the U.S. to invest in U.S. debt," said David Walker, a former U.S. comptroller general who heads an advocacy group calling on the government to curb the U.S. budget deficit and borrowings.

To be sure, the idea that China would suddenly sell its U.S. debt holdings is almost unimaginable to some.

After all, any weakening in the U.S. debt markets and the resulting global markets turmoil, including likely weakness in the dollar, would bounce back on China and could hurt its economy badly, especially as the United States is such a huge Chinese export market.

It likely would take something like a massive rise in tensions over an issue like Taiwan or oil exploration in disputed areas of the South China Sea, including possible military confrontation between the two nations. Such a confrontation would also make it easier for Washington to appeal to the American public to buy its debt for patriotic reasons.

But Beijing could also justify pulling back sharply from U.S. Treasuries if the dollar were to plunge, perhaps because of Washington's failure to curb its budget deficit and debt.

"I worry that we could be at a tipping point," said Eswar Prasad, a Brookings Institution economist and former International Monetary Fund official with responsibility for China.

"If the Chinese say 'We're not buying any more Treasuries,' this could act as a trigger around which nervous market sentiment coalesces," he said. "People could start wondering how the U.S. is going to finance its deficit."

APPEAL TO OTHER COUNTRIES

In 2009, economist Brad Setser suggested the United States could establish emergency currency swap lines with political allies if a country like China ever abandoned the U.S. debt market.

But the list of countries prepared to step in as buyers when U.S. Treasury officials try to hawk U.S. debt or seek foreign currency loans has probably changed somewhat since Europe became mired in a debt crisis.

Since Setser's proposal appeared in a memo published by the Council on Foreign Relations, Germany has had to throw billions of euros behind other euro zone countries' debt to keep the euro zone intact. With other European countries drawing on swap lines established by the Fed, they are hardly in a position to support the United States.

Japan could step in with some additional purchases, but they may be limited, given it has a massive domestic debt burden and is currently campaigning for more Japanese savers and companies to buy its own debt.

Other countries in the region that already buy large amounts of U.S. Treasuries to try to keep the value of their currencies from climbing, such as Thailand and India, or countries with large sovereign wealth funds, such as Singapore, could also be called on to increase their purchases.

Then there are the oil producers in the Middle East, such as Saudi Arabia and the United Arab Emirates, which have traditionally been seen as American allies. Together, the region's oil producers hold around $210 billion in Treasuries.

"These countries all have a massive amount of dollars invested in Treasuries already," said Eric Stein, vice president and portfolio manager at Eaton Vance in Boston. "It would be hard for them to commit to incrementally increase their holdings."

Nevertheless, analysts think a pledge by several major powers to support U.S. debt prices with scheduled purchasing operations could calm the Treasury market.

The price for the United States could be high, though. One banker who wished to remain anonymous suggested that in an extreme scenario, the United States might even need to peg the dollar to a basket of other currencies to reassure foreign investors that their purchases would not suddenly devalue.

QE-3?

Another quick fix would see the Fed step in -- again.

After all, at $600 billion, the size of the Fed's second quantitative easing program, announced November 3, is larger than the total amount of Treasuries China bought in 2010.

According to Treasury data released on Tuesday, China's gross purchases of long-term Treasuries totaled roughly $260 billion from January to November last year, with China remaining the largest single holder of Treasuries.

But Fed purchases might only work if inflation were still low and the economic recovery sluggish.

Otherwise it might backfire as the perception that the Fed was printing money and devaluing the dollar could cause the currency to take a big hit and bring down other U.S. assets, including treasuries, with it.

"The Fed could try to intervene, but if that led to higher future inflation expectations, it would not hold down rates but rather push them up," said Benn Steil, senior fellow and director of international economics at the Council on Foreign Relations.

Treasury officials already tout the increasing demand for Treasuries from U.S. domestic savers. But Walker, the former comptroller general, sees potential for a more aggressive effort to market Treasuries to Americans that could help shift the government away from dependence on foreign creditors.

In his view, the efforts would have to include an appeal to patriotism and come with a longer-term plan to rein in the budget deficit.

"What we need to do is have a plan that's reasoned, reasonable, can reassure our foreign lenders and also demonstrate to the American people that Washington can get something done," Walker said.

Eaton Vance's Stein said U.S. banks could also be pressured, or even forced, to buy more treasuries as part of their capital cushions.

"It seems maybe on some level unbelievable that that would happen in the U.S.," Stein said. "But other countries even now, if they can't find anyone to take down their paper, will turn to domestic banks."

(Editing by Martin Howell and Dan Grebler)
