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China holds more U.S. debt than indicated

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Despite recent government reports that China's holdings of U.S. Treasury debt declined during the second half of last year, the Asian economic giant almost certainly owns far more Treasury securities than official statistics indicate.

After peaking at $801.5 billion, China's holdings of U.S. Treasury securities declined to $755.4 billion at the year's end, dropping the communist power into the position of second-largest holder of Treasury debt after Japan's $768.8 billion, official government data reveal.

But these numbers don't tell the whole story.

"The U.S. Treasury data almost certainly understate Chinese holdings of our government debt because [the U.S. figures] do not reveal the ultimate country of ownership when [debt] instruments are held through an intermediary in another jurisdiction," Simon Johnson, an economics professor at the Massachusetts Institute of Technology, told the U.S.-China Economic and Security Review Commission, a bipartisan forum established by Congress in 2000 to monitor the security implications of the U.S. economic relationship with China.

Mr. Johnson told the commission last week that "a great deal" of last year's $170 billion increase in Treasury holdings by the United Kingdom "may be due to China placing offshore dollars in London-based banks" and then using the funds to purchase Treasury debt.

Mr. Johnson, a former chief economist for the International Monetary Fund, estimated that China owns about $1 trillion in U.S. Treasury securities, or nearly half the $2.37 trillion stock of Treasury debt held by "foreign official" owners.

The amount of U.S. debt held by China is even higher than that, said Eswar Prasad, an economist at Cornell University.

Under the widely held assumption that 70 percent of China's $2.4 trillion in foreign exchange reserves is invested in dollar-denominated bonds, Mr. Prasad told the commission that China probably holds about $1.7 trillion in U.S. government debt.

That would include the more than $400 billion in debt issued by U.S. government agencies, such as Fannie Mae and Freddie Mac, whose obligations are liabilities of the U.S. government, Mr. Prasad said.

Derek Scissors, a China scholar at the Heritage Foundation, described as "unusable" the official U.S. government data on foreign holdings of Treasury debt.

China's mercantilist policies generate "by far the world's largest balance of payment surpluses" and contributed to China's $453 billion increase in foreign exchange reserves last year — surpluses that "are too large to put anywhere other than the United States. No other country has financial markets capable of absorbing them," Mr. Scissors said.

But the economists at last week's hearing disagreed about how much leverage China's creditor status commands over the U.S.

Maj. Gen. Luo Yuan told China's state-run Outlook Weekly magazine last month, shortly after the U.S. detailed new arms sales to Taiwan, that China's "retaliation should not be restricted to merely military matters" but also should be "covering politics, military affairs, diplomacy and economics."

"We could sanction them using economic means, such as dumping some U.S. government bonds," Gen. Luo said.

Michael Wessel, a member of the U.S.-China commission, began the hearing by noting that China, whose economy expanded by 10.7 percent during 2009, "emerged from the global recession stronger than ever, expecting its status as America's banker to convey new political power."

"The United States government, with its fiscal and monetary tools constrained by the recession, cannot easily extricate itself from its growing financial dependence on China," he said.

Leverage, however, works both ways, Mr. Wessel suggested, when he quoted oil magnate J. Paul

Getty. "If you owe the bank $100, that's your problem," Getty famously said. "If you owe the bank $100 million, that's the bank's problem."

Mr. Johnson also downplayed China's leverage.

"There is a perception that China's large dollar holdings confer upon that country some economic or political power vis-a-vis the United States," said Mr. Johnson, citing the view that Chinese reserves prevent the United States from pressuring China to increase the value of its currency, the yuan, also known as the renminbi. "This view is incorrect and completely misunderstands the situation."

Daniel Drezner, a professor of international politics at the Fletcher School of Law and Diplomacy at Tufts University, compared today's financial situation between China and the U.S. to the Cold War nuclear situation between the Soviet Union and the U.S.

He argued that the "balance of terror," which was connected with the nuclear policy of mutually assured destruction adopted by both adversaries, proved to be "a source of stability."

Mr. Drezner approvingly cited the analogy of Lawrence H. Summers, President Obama's chief economic adviser, who earlier coined the phrase "the balance of financial terror" to describe the U.S.-China financial relationship. Such a scary balance, Mr. Drezner told the commission, is "a source of stability and a source of anxiety."

Economists generally agree that the yuan is 25 percent to 40 percent undervalued, in large part because Chinese authorities instruct the central bank to purchase massive amounts of dollars in order to peg the yuan's value to the dollar at a level much lower than it otherwise would be, Mr. Johnson said.

A bipartisan coalition in Congress wants the Treasury Department to label China a currency manipulator in its next report, due April 15. Such a designation would require the Treasury Department to begin negotiations with China to let its currency rise in value and reduce the massive U.S. trade deficit with China, which has exceeded $200 billion for each of the past five years.

Under legislation proposed in Congress, currency manipulation would be designated as an unfair trade subsidy and would let U.S. companies seek import duties on Chinese goods.

"China is obviously a currency manipulator and should be so labeled by the U.S. Treasury," Mr. Johnson said.

Mr. Johnson called Chinese threats to dump dollar-denominated assets a "paper tiger" and "at worst a bluff and at best a way to help the U.S. with a depreciation of the dollar."

Mr. Scissors agreed. "Until the Chinese government is willing to break its dependence on the dollar — which there is not the slightest indication it is willing to do — [China] is compelled to buy American bonds and lacks the flexibility to wield any influence," he said.

Mr. Johnson said the current U.S. economic situation ensures that a substantial downward movement in the dollar "would have no noticeable effect on inflation and therefore would not force the Federal Reserve to increase interest rates."

Mr. Prasad, however, noted that the damage to the two countries' economies would not be equal.

"Any Chinese threat to move aggressively out of Treasuries is a reasonably credible threat as the short-term costs to the Chinese of such an action are not likely to be large," he said.

Moreover, even though China's share of the financing of the soaring U.S. budget deficit has declined over time, its actions still could affect U.S. interest rates, Mr. Prasad said.

"Its actions could serve as a trigger around which nervous market sentiments could coalesce," Mr. Prasad said. "Given that there are no clear prospects of reining in exploding deficits and debt in the U.S.," he added, "changes in availability of deficit financing at the margin can have potentially large consequences."

Mr. Scissors estimated that U.S. interest rates would rise at most three percentage points.

However, with U.S. national debt set to exceed $14 trillion before the end of the year, a three-percentage-point increase in interest rates would raise the annual cost of paying interest on that debt by more than $400 billion.

The commission was told that U.S. policymakers also need to consider the geopolitical and national security implications of operating a fiscal policy that depends on China and other foreign creditors, who collectively hold 50 percent of U.S. publicly held debt.

Clyde Prestowitz, president of the Economic Strategy Institute, recalled for the commission Britain's experience with the United States in 1956 after Britain joined France and Israel in seizing the Suez Canal after Egypt's nationalization of the waterway.

"President Eisenhower was furious over the seizure of Suez and informed the Brits that America would ruin the pound sterling if Britain did not withdraw," Mr. Prestowitz said. "And that was the end of the seizure.

"Now, America is not Britain and China is not America," Mr. Prestowitz said. "But if that is how your friends can treat you when you owe them, it is not difficult to imagine that less-friendly states could be quite difficult in certain circumstances."