



Should We Be Grateful to China for Buying U.S. Treasuries?

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Executive summary

The current economic relationship between the United States and China is perilous for both countries. The nature of that peril is quite different than is commonly perceived.

China's large and rapidly growing stash of U.S. treasuries is only part of a much larger debt issue that is driven by trade deficits rather than the size or direction of U.S. fiscal policy. In fact, there is little evidence to support a significant connection between budget deficits and trade deficits given U.S. experience over the past 18 years.

U.S. trade deficits have grown from \$80 billion in 1990 to \$680 billion in 2008. Yet most of this growth took place during years in which the budget deficit or surplus was improving. The United States' fiscal condition improved steadily between 1995 and 2006, swinging from a \$164 billion deficit to a \$236 billion surplus. There was not a commensurate improvement in the trade deficit during this period as many economists might have predicted; instead, the United States' trade deficit quadrupled going from \$96 billion in 1995 to \$380 billion in 2000. Again between 2004 and 2006 when the budget deficit shrank from \$412 billion to \$248 billion, the trade deficit continued upward from \$607 billion to \$753 billion.

China has played a central role in the growth of U.S. trade deficits, and that role has grown steadily more important with the passage of time. China has accounted for 60 percent of the growth in the trade deficit since 2000.

Unlike most nations around the globe and throughout history, China's interest in exporting has extended well beyond earning the foreign currency needed to purchase goods and services from overseas. China has dedicated 40 percent of its output to export production, severely limited the purchases of goods and services from outside its own borders, and built gigantic foreign reserves at the same time. Chinese leaders have furthermore made several key policy decisions that severely limit how the country can spend those reserves. Their desire to keep their own currency weak against other leading currencies—the dollar in particular—means that China cannot trade the dollars they collect on world currency markets. It can only invest in dollar denominated assets, namely U.S. real estate, equities, and debt.

The U.S. Treasury has identified a significant portion of the dollars that have been reinvested into the United States by the Chinese since 2000. Of the \$1.4 trillion in trade surpluses during that period, \$96 billion went to buying stock in U.S. companies, \$16 billion was invested in corporate bonds, \$474 billion was used to buy the debt of government chartered organizations such as Fannie Mae, and \$439 billion was put into U.S. treasuries. The remaining \$400 billion remained in Chinese banks, was invested in American real estate, or entered the United States through foreign intermediaries and credited to the holdings of the countries in which the purchases occurred rather than the ultimate owner of the holdings.

China's use of its export earnings has remained relatively constant over the past eight years. The portion allocated to ownership of corporate stocks and bonds has fluctuated between 5 and 11 percent. The portion allocated to treasuries and debt from government-chartered organizations has fluctuated between 89 and 94 percent.

Examining the pattern of Chinese investments over the past year provides significant insight into how China is likely to invest the \$300 billion or so it is likely to make from the United States in export and investment earnings during the coming year. China is struggling to learn more about investing in U.S. equity markets, but neither Chinese leaders nor the Chinese people are likely to develop sufficient tolerance for risk that ventures very far from the current pattern of dividing 90 percent of the nation's growing horde of dollars between U.S. government chartered debt and treasuries.

If China were to substantially reduce the amount of treasuries it purchases and instead invest in real estate, stock, or corporate debt, it could be helpful for the U.S. economy. It would reduce the record high spread between what businesses must pay to borrow money and what the U.S. government must pay. Furthermore, the current reservoir of global savings, which is more than \$15 trillion per year, is likely to grow due to savings from business and consumer caution. The economic downturn and investors' desire for safety in turbulent markets points to continued high demand for treasuries even in the face of lower Chinese participation.

But China's accumulation of U.S. debt is unsustainable. It will ultimately force a devaluation of the dollar against other world currencies and a diminution of the value of Chinese holdings. Beyond that, China's current growth strategies are absurd at their foundation. China has a per capita gross domestic product that is lower than Congo, Namibia, Albania, or the Dominican Republic. It redirects half of that per capita GDP back into savings, which denies impoverished Chinese citizens much of the quality of life that their labors have earned them. Ordinary workers in China, who consider themselves lucky to be able to get a \$40 a week job in an export-oriented factory, are loaning nearly \$1 billion a day to a country where median family income approaches \$1,000 a week.

China's policies appear to have a lot more to do with politics than economics. The ruling elite are the revolutionaries' grandchildren and great grandchildren. They know that the whims of the masses can be fickle and that the occupants of the Forbidden City can be driven from its gates. They know that the nation is severely divided by region, dialect, and ethnicity. They know that more fully sharing in the fruits of China's success would make the economy more difficult to control, and while freer economies offer many benefits, they tend to involve cycles that can entail serious political risk.

A realignment of this relationship will eventually be forced by the fundamental unsustainability of the status quo. Yet a precipitous realignment will be extremely painful to the economic wellbeing of both countries and the world economy, as well. If steps are taken now to rebalance the relationship the course forward can be much smoother and living standards in both countries will be placed at substantially less risk.

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