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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 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 $1,205 billion, making China the 2nd 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.

U.S. Treasury securities are issued to finance the federal budget deficit. Of the public debt that is privately held, about half is held by foreigners. As of December 2008, China's Treasury securities holdings were $727 billion, accounting for 23.6% of total foreign ownership of U.S. Treasury securities, making it the largest foreign holder of U.S. Treasuries (replacing Japan in September 2008). .

Some U.S. policymakers have expressed concern that China might try to use its large holdings of U.S. securities, including U.S. public debt, as leverage against U.S. policies it opposes. For example, in the past, some Chinese officials reportedly suggested that China could dump (or threaten to dump) a large share of its holdings to prevent the United States from imposing trade sanctions against China over its currency policy. Other Chinese officials reportedly stated that China should diversify its investments of its foreign exchange reserves away from dollar-denominated assets to those that offer higher rates of returns. The recent global financial crisis has heightened U.S. concerns that China might reduce its U.S. asset holdings.

A gradual decline in China's holdings of U.S. assets would not be expected to have a negative impact on the U.S. economy (since it could be matched by increased U.S. exports and a lower trade deficit). However, some economists contend that attempts by China to unload a large share of its U.S. securities holdings could have a significant negative impact on the U.S. economy (at least in the short run), especially if such a move sparked a sharp depreciation of the dollar in international markets and induced other foreign investors to sell off their U.S. holdings as well. In order to keep or attract that investment back, U.S. interest rates would rise, which would dampen U.S. economic growth, all else equal. Other economists 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. This report will be updated as events warrant.

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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 $1.95 trillion as of December 2008. 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. In addition, China's FER are expected to continue to grow rapidly in the near future, potentially continuing (and possibly increasing) China's role as a major buyer of U.S. securities.

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 could be a major purchaser of new U.S. government debt.

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, the likelihood that this would occur, 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

[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.

$216 billion in 2001 to $1,528 billion in 2007, to $1,946 billion as 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.

Table 1. China's Foreign Exchange Reserves: 2001- 2008

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

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

Note: Year-end values.

A listing of the world's top five holders of FER as of December 2008 is shown in **Table 2**. Not only was China by far the world's largest FER holder, its accumulation of additional reserves from 2006-2008 ($878 billion) was significantly larger than the combined FER increases of the other four major holders – Japan, Russia, Taiwan, and India.[3] According to the IMF, as of June 2008, China accounted for 26.2% of the world's FER.[4]

Table 2. Top 5 Holders of Foreign Exchange Reserves and Changes to Holdings From 2006-2008

Country	Reserves (billions of U.S. dollars)			
	2006	2007	2008	Change in Reserves: 2006-2008
China	1,068.5	1,528.2	1,946.0	877.5
Japan	879.7	948.4	1,003.3	123.6
Russian Federation	295.3	386.2	406.2	110.9
Taiwan	266.1	270.0	291.7	25.6
India	170.2	266.6	246.6	76.4

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

Note: Ranked according to total holdings as of December 2008.

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

[4] Total reserves for all countries in June 2008 were estimated at $6,894.1 billion. Worldwide, 41% of reserves were held in dollar-denominated assets.

China's Holdings of U.S. Securities[5]

China's central bank 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, the 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.[6] 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,[7] LT corporate securities (some of which are asset-backed), equities (such as stocks), and short-term debt.[8]

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 billion (or 31%) larger than June 2007 levels, and were nearly five times 2003 levels (see **Figure 1**).[9] These increases were significantly more than that of any other major foreign holder.[10]

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

[6] 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.

[7] 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).

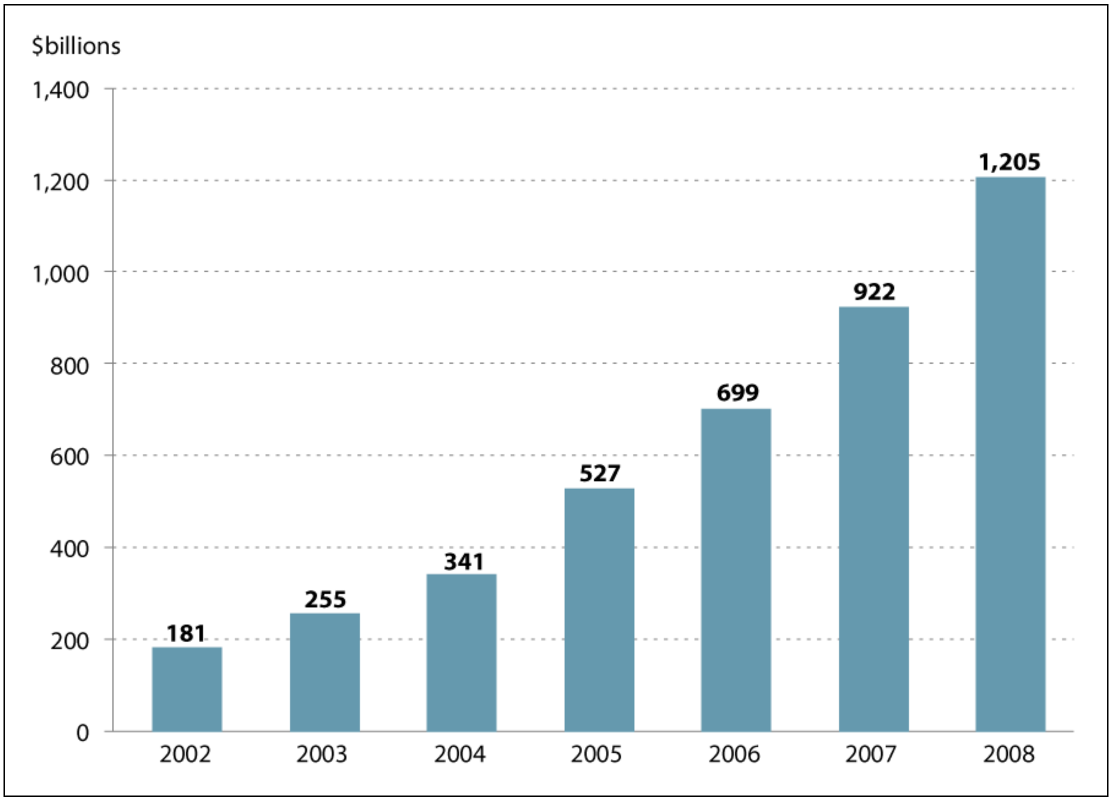
[8] LT securities are those with no stated maturity date (such as equities) or with an original term to maturity date of more than one year. Short-term debt includes U.S. Treasury securities, agency securities, and corporate securities with a maturity date of less than one year.

[9] Data on China's holdings of U.S. securities exclude holdings by Hong Kong (which totaled $147 billion as of June 20080 and Macao. These entities, though part of China, are reported separately by Treasury.

[10] In comparison, Japan's holdings grew by only $53 billion.

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.[11] China may have become 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

). This appears to indicate that the Chinese government has been pursuing 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).

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%.[12] If this figure is correct,

[11] 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.

[12] 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%.

China's holdings of U.S. securities may have reached $1.36 trillion or higher as of December 2008.[13]

It is not clear to what extent China's investments have gone into 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. 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.[14]

U.S. data indicate 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 (up from 29% as of June 2007). The second biggest category of new U.S. securities holdings in 2008 was in equities, which increased by $71 billion.

It is not yet clear how the U.S. sub-prime and financial crisis and ensuing global financial crisis has affected China's purchases of U.S. securities, especially since the extent of these crises became more apparent after June 2008. [1] 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 to these securities.

[13] 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.

[14] The Bank of China either reduced its holdings or wrote off the losses.

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

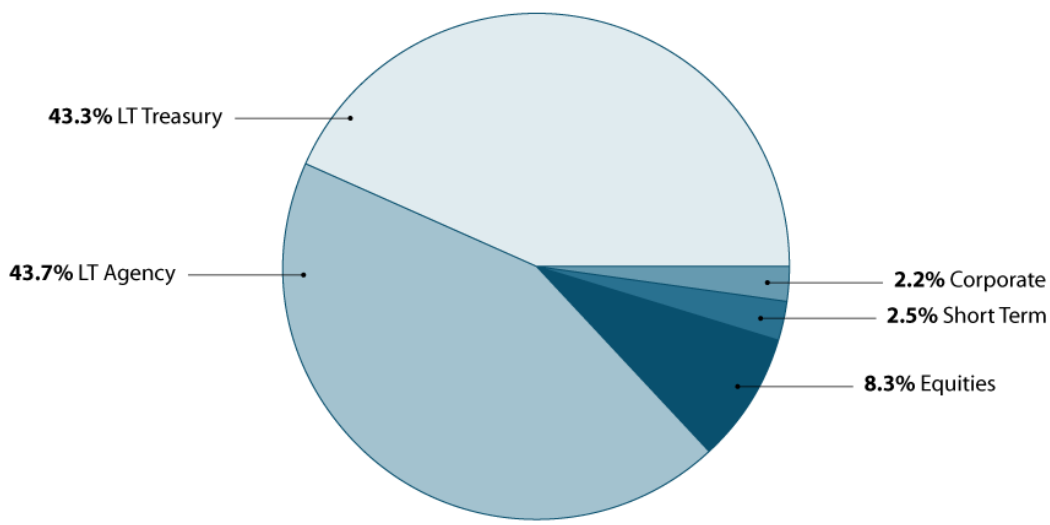
($ billions)

Type of Security	Total	LT Treasury	LT Government Agency	LT Corporate	Equities	Short Term
Japan	1,250	568	270	148	199	66
China	**1,2051**	**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.

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.

China's Ownership of U.S. Treasury Securities[16]

U.S. Treasury securities are the main vehicle the U.S. government uses to finance the federal debt, which totaled $10.0 trillion at the end of September 2008. Of this amount, 47% was held by U.S. government trust funds and 53% was privately held. Of the total level of privately-held U.S. Treasury securities ($5.3 trillion), foreigners owned 54% of the total ($2.9 trillion).[17] China's holdings of U.S. Treasury securities holdings (as of September 2008) accounted for 11.0% of total private holdings (including foreign governments and citizens) of U.S. Treasury securities and 5.9% of total U.S. public debt securities (combined public and private).[18]

Table 5 lists the top five major foreign holders of U.S. Treasury securities as of December 2008. China was the largest holder of U.S. Treasury Securities (overtaking Japan in September 2008) at $724 billion; it was the 7th largest holder in December 1997.[19] Over the past few years, China has become a major purchaser of Treasury securities. From December 2002 to December 2008, China's share of total foreign holdings of U.S. Treasury securities rose from 9.6% to 23.6%. From December 2007 to December 2008, China's holdings increased by $250 billion (or 52.3%), by far the largest dollar increase of any country. China accounted for 34.4% of net new holdings of U.S. Treasury securities in 2008. In comparison, Japan's holdings rose by $46.1 billion. China's purchases of U.S. Treasury securities were relatively large in September and October 2008, at $44.5 billion and $65.9 billion, respectively. This may in part reflect a movement by China (and other foreign investors) away from purchases of U.S. agency asset-backed securities (such those issued by Fannie Mae and Freddie Mac) to more "safe" U.S. Treasury securities (especially short-term securities).

Table 4. China's Holdings of U.S.Treasury Securities: 2002-2008 Year-End

$billions and as a percent of total foreign holdings

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

Source: U.S. Treasury Department.

[16] 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.

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

[18] 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.

[19] Treasury constantly revises its estimates of foreign holdings of U.S. securities. On February 27, 2009, it made substantial revisions to its previously released monthly data for 2008 (which was issued on February 17, 2009). The new data raised estimates for China's holdings of U.S. Treasury securities in December 2008 from $696 billion (old estimate) to $727 billion. However, Treasury does not revise its data from previous years. Thus, comparisons of historical Treasury data should be viewed with caution.

Table 5. Major Foreign Holders of U.S.Treasury Securities: December 2007 and December 2008

($ billions)

	Dec 2007	Dec 2008	Dec 2007-Dec 2008 Change in the Value of its Holdings	Holdings as a Share of Total Foreign Holdings as of Dec 2008 (%)
China	477.6	727.4	249.8	23.6
Japan	579.9	626.0	46.1	20.3
Caribbean Banking Centers	117.4	197.5	80.1	6.4
Oil Exporters[a]	137.9	186.2	48.3	6.3
United Kingdom	157.9	130.9	-27.0	4.3
Total Foreign Holdings	2,351.1	3,076.9	725.8	100.0

Source: Department of Treasury, *Major Foreign Holders of Treasury Securities Holdings*, February 27, 2008.

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. A new survey may often significantly revise data of a previous survey. Thus, time series data should be viewed with caution.

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

Some U.S. policymakers have expressed concern over China's large holdings of U.S. securities, including Treasury securities, contending that China could use it as a political tool against 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 a renminbi revaluation, and that the threat to do so could be used as a "bargaining chip."[20] The article prompted concern among many U.S. policymakers, including Senator Chuck Grassley, who, in an August 9, 2007 letter to the Chinese ambassador to the United States (Zhou Wenzhong), called the comments "dangerous" and a factor in why the United States "is right to be concerned with China's currency practices." The letter asked the Chinese government to confirm that "the comments do not reflect the official position of the Chinese government."[21] In response, the Chinese ambassador wrote to Senator Grassley on August 13, 2007, that "China does not have a plan to drastically adjust the structure of its foreign reserves."[22] In addition, China's *Xinhua News Agency* on August 13, 2007, quoted an unnamed official at the People's Bank of China as stating that "dollar-denominated assets, including U.S. government

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[20] The Telegraph, *China Threatens 'Nuclear Option' of Dollar Sales*, August 7, 2007.

[21] See text of letter at http://grassley.senate.gov/public/.

[22] Letter reprinted in *Inside U.S. Trade*, August 13, 2007.

securities, are an important component in China's foreign exchange reserve investment portfolio," and that China was "a responsible investor."

Numerous reports have appeared in the media citing various Chinese officials who, in the past, have claimed or hinted at government plans to reduce its holdings of U.S. Treasury securities for economic reasons. For example, on September 29, 2007, the Chinese government officially launched the state-owned *China Investment Corporation*, which Chinese officials state was created to better manage its foreign exchange reserves. It reportedly will initially manage over $200 billion of China's reserves, making it one of the world's largest sovereign wealth funds. Some contend the creation of this entity could signal Chinese plans to diversify away from relatively low-yielding assets, such as Treasury securities, and perhaps dollar-denominated assets in general.[23] On November 7, 2007, Cheng Siwei, the vice chairman of the Chinese National People's Congress, reportedly made remarks that the Chinese government "will favor stronger currencies over weaker ones, and will readjust accordingly." The media claimed that his remarks were a major factor in sparking a sharp decline of the dollar against the euro in international currency markets that day.[24] However, on November 14, 2007, Yi Gang, assistant governor of the People's Bank of China, was quoted as saying that "the U.S. dollar is the main currency in our reserves and that policy remains very firm," and said that statements by other officials to the contrary were "opinions."[25]

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.[26] At a press conference during her visit to China on February 21, 2009, Secretary of State Hillary Rodham Clinton brought up this issue, stating that she appreciated "greatly the Chinese government's continuing confidence in the United States treasuries."

What If China Reduces its Holdings of U.S. Securities?[27]

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.

[23] Others are concerned that China will attempt to use the fund to purchase major U.S. companies. See the New Yorker, *Sovereign Wealth World*, November 26, 2007. According to the article, "were China's fund so inclined, it could buy Ford, G.M., Volkswagen, and Honda, and still have a little money left over for ice cream."

[24] *Bloomberg News*, November 8, 2007.

[25] *China Daily*, November 15, 2007.

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

[27] 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.

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.[28] 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.[29] 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 $1,205 billion of U.S. government assets as of June 2008 (and possibly $1.4 trillion at the end of 2008), 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 would not cause a recession since it would ultimately lead to a trade surplus (or smaller deficit), which expands aggregate demand.[30] (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.)[31] However, a sudden increase in interest rates could swamp the trade effects and cause (or worsen)

[28] 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.

[29] 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.

[30] 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.

[31] 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.

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 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.[32] This would also occur if the value of the dollar were greatly diminished in international currency markets due to China's sell-off.[33] 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).[34] 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).[35] 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.

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.[36] 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.[37] Some economists argue that at

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[32] 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.

[33] 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.

[34] 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.

[35] 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).

[36] 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 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.

[37] 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 (continued...)

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.[38] 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.[39]

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).[40] 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.[41] 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 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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as a percent of GDP 5.3% in 2007 and to 4.8% in 2008.

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

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

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

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

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