China hedging its bets on U.S. government debt, data show

The nation's slowing accumulation of U.S. Treasuries suggests it is trying to diversify its holdings and is looking for other places to stockpile its trove of foreign exchange.

By David Pierson, Los Angeles Times

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Reporting from Beijing

China's massive holdings of U.S. government debt have bolstered the American economy by keeping interest rates low. Now signs are emerging that Uncle Sam's banker is hedging its bets.

China's holdings of U.S. Treasuries accounted for 54% of its foreign-exchange reserves as of June 30, according to a U.S. Treasury survey released this week. That's down from 65% in 2010 and a record 74% in 2006.

Beijing continues to buy loads of U.S. debt. As of June 30 it held $1.73 trillion in U.S. securities, up 7% from June 30, 2010.

Still, other federal data show it was a net seller of U.S. treasuries in the second half of 2011.

The slowing accumulation of U.S. debt suggests China is trying to diversify its holdings and is looking for other places to stockpile its trove of foreign exchange.

Experts have long warned about a rise in U.S. interest rates and resulting damage to the economy if China abruptly tightened the credit spigot. But there appears little threat of that at present.

China, the largest foreign holder of U.S. government debt, has few good options for parking its foreign exchange. Nothing can match the safety, liquidity and size of the U.S. Treasury market.

"There's no substitute," said Liu Baocheng, a professor at the University of International Business and Economics in Beijing. "The dollar remains the dominant currency."

In addition, Beijing knows that a sell-off of its U.S. holdings could weaken the dollar, eroding the value of its investments.

Global demand for U.S. Treasuries has remained strong in an uncertain environment. The yield on the 10-year note fell 0.05 of a percentage point to 1.98% in New York on Friday as investors sought a haven from continued worries about the Eurozone.
"The conceptual framework people have that China is America's banker and America is dependent on financial inflows from China is not true," said Andrew Batson, a Beijing-based analyst for GaveKal-Dragonomics. "The proof is in the pudding. China was buying a much smaller number of U.S. assets and no one even noticed."

Exactly where China is turning for diversification is unclear. Beijing does not disclose where it puts its foreign reserves.

"My suspicion is China is buying a little bit of everything," Batson said. "They're probably in a lot of smaller currency markets like the Australian dollar, the Canadian dollar and the Brazilian real. [But] these markets are small relative to the size of Chinese funds available."

Batson said the only other debt markets comparable in size to the U.S are Japan and Europe, but noted data from Japan suggested that China wasn't buying much there.

"By process of elimination that means more money is going into the euro, which was pretty strong last year," he said.

China could also be holding back U.S. purchases in preparation for an aid package to the Eurozone, Liu said.

European leaders have implored China to participate. Experts suspect Beijing is holding out for concessions such as rules that would make it harder for trading partners to bring unfair trade cases against China.

Chinese policymakers and economists have long advocated reducing the country's reliance on the dollar. Beijing has bristled at Washington's stimulus efforts because they weaken the dollar and, therefore, the value of China's holdings.

Tension peaked last summer when U.S. lawmakers were debating whether to raise the nation's debt ceiling. The resulting downgrade of U.S. debt by ratings firm Standard & Poor's served as a sharp reminder to China of how Beltway politics can affect its interests.

Critics counter that China wouldn't be in its predicament if it hadn't pursued policies that have given it a massive trade surplus, including undervaluing its currency, the yuan.

That argument has weakened in recent months, however. China's trade surplus has narrowed because of rising imports and a strengthening yuan, another reason China's purchases of U.S. debt may be slowing.

China's foreign reserves have essentially remained unchanged since the first half of last year.

"China's previously gigantic balance of payments surplus vanished in the second half of 2011," said Derek Scissors, a Washington-based China specialist at the Heritage Foundation. "They moved from having too much money to place to having no new money to place at all. If you don't have more money, you can't buy anything new."

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