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U.S. Debt to China: Implications and Repercussions

Recent Federal Reserve Bank of New York statistics indicate that China has been replaced by Japan as the largest investor in U.S. Treasury Securities. In December of 2009, the bank reported that Japan held $769 billion of Treasury securities compared to $755 for China. However, the statistics also showed U.K. holdings of $303 billion, Caribbean Banking Center holdings of $185 billion, and Hong Kong holdings of$153 billion. Since other investors often make investments through the UK and Caribbean centers, the exact holdings of each country are not always clear. Moreover, since Hong Kong is a special administrative region of China, its holdings could be counted as Chinese which would put China back on top.

More important, however, is the fact that regardless of which country holds the most Treasury securities, China is far and away the largest holder of U.S. dollars with a hoard of between $2.5 and $3 trillion and rising. This, of course, makes it the largest overall financier of American debt as well as an increasingly major investor in a wide range of U.S. and third country assets. Indeed, next to the United States itself, China is probably the world's most important financial player. What are some of the implications of this rise in Chinese financial power?

In one sense, it actually facilitates both America's economic recovery policies and the further playing of its role as the hegemonic global power. Without the lending of the Chinese (and of others like Japan), U.S. economic stimulus efforts would be much more constrained and the United States would long since have brought the troops home from Iraq, Afghanistan, and many more of the over 800 bases it maintains around the world. So, in one sense, we could say that China is financing the rebuilding of New Orleans, the reconstitution of the U.S. banking system, and

U.S. military activities around the world including the patrolling of off-shore China waters by the U.S. Seventh Fleet.

On the other hand, this financing can also be considered as vendor financing in a giant Chinese-American Ponzi scheme. China's growth depends on exports and they depend to a significant extent on American consumption. Indeed, one could say on American "over-consumption." China subsidizes its exports in a number of ways and the financing of U.S. debt enables the subsidization through currency undervaluation and other methods. In this way, it subsidizes U.S. consumption, but also undermines U.S. based production of tradable goods and services, and, in the long run, the productive base that underpins the U.S. global role.

Financial power is, of course, almost always linked to political power and influence. By dint of its financial role, China has gained significant political influence in the United States and around the world. As a major investor in some of America's leading financial groups, Chinese government related funds have become a significant part of the Wall Street lobby that wields such enormous influence here in Washington. The U.S. government's ability to enforce some of the key rules of international trade and finance is inhibited by America's financial dependence on China. This is not to say that the United States does not have some countervailing power. It does. Just as America needs Chinese money, China needs the American market and the American provision of international public goods. So we have cards to play, but we play them much more cautiously than we otherwise might.

Historically, it has never been a good thing for countries to accumulate large debt burdens and especially it has not been good to accumulate such debt burdens to other countries – even to other very friendly countries. In his book, The Rise and Fall of the Great Powers, Paul Kennedy records that a prime cause of the fall of the powers was the increasingly unsupportable burden of foreign debt. Perhaps the most telling example is that of Great Britain and the United States during the attempted 1957 seizure of the Suez Canal by Britain, France, and Israel. Britain still fancied itself a great power at the time and was so regarded by much of the rest of the world. It still maintained a vast empire and the sun still did not set on the British flag. But Britain was heavily in debt to, among others, the United States, its closest friend and ally among the nations. 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. And that was the end of the seizure. Now, America is not Britain and China is not America. 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.

China has voiced increasing concern about the future of America's debt, the dollar, and the value of the Chinese dollar holdings. It has also indicated that it is trying to diversify its reserve holdings a bit away from the dollar. It is right to be concerned and it would be foolish not to attempt to diversify. That, after all, is the iron law of investment. Never mind that China may be the ultimate cause of much of its own concern. It nevertheless, must look a the trajectories and try to allocate its resources accordingly. Current trends indicate continuing U.S. current account deficits in the 3-7 percent of GDP range and U.S. federal budget deficits in the $1 trillion dollar plus range. If not reversed at some point, those trends will inevitably lead to the debasement of the dollar and the bankruptcy of the United States. So China will try to hedge against that by diversifying.

Diversification, however, will not be easy because there is no good alternative to the dollar and because the very act of diversification may tend to undermine the value of China's holdings. So it will move carefully and cautiously. It may buy more gold, more oil fields, more agricultural land in Africa, and so forth. But there will be limits to that as well. We and China and the world, desperately need to develop a whole new approach.