



the last four quarters (q4 2007 to q3 2008) China added around \$700 billion to its foreign assets. That is more than shows up in the official data, as about \$300 billion of the growth came from China's hidden reserves (the PBoC's "other foreign assets" and the CIC). The rise in China's foreign assets during the last four quarters exceeds the combined foreign assets of the world's oil exporting economies over the same

Table 1. Estimated foreign assets of China's government

	Q3 2008
Fx Reserves (managed by SAFE)	\$1900b
“Other foreign assets” of PBoC (managed by SAFE)	\$210b
State banks	\$150-200b
CIC (excluding assets managed by state banks)	\$100-120b
TOTAL	\$2350-\$2400b

This is how it works: Everyday, the People's Bank of China buys foreign exchange from China's state banks. China's new sovereign wealth fund – the China Investment Corporation – buys some of the foreign exchange from China's central bank. But most of the foreign exchange is still handed over to China's State Administration of Foreign Exchange (SAFE) to be invested abroad. SAFE consequently faces a daily challenge to find new assets to add to China's portfolio. It likely sells some of China's dollars for other currencies. But it generally uses the dollars it receives from the central bank to buy US bonds. Day after day, it is the single largest buyer of Treasury bonds in the market. And day after day, it is – or perhaps was – the largest buyer of so-called Agency bonds (the bonds of Freddie Mac, Fannie Mae, Ginnie Mae and the Federal Home Loan banks – all initially “Agencies” of the US government).

Obtaining an accurate picture of China's purchases and its total foreign portfolio is a puzzle. China neither discloses the currency composition of its foreign exchange reserves nor participates in the IMF's global survey of the currency composition of reserves. The CIC discloses even less information. Piecing together a picture of China's foreign purchases includes data from the US Treasury data on foreign portfolio investment in US securities. But the Treasury's monthly data systematically understates China's actual purchases. The best figures come from the Treasury's annual survey of foreign portfolio holdings of US securities, which consistently shows a far larger increase in China's holdings of US assets than implied by the monthly data on China's purchases.<sup>1</sup> Unfortunately, the last survey was in June 2007 – when China had far fewer foreign assets than it has now.

Getting a reasonably accurate picture of China's current holdings of US assets consequently requires a bit of educated guess work. Arpana Pandey of Council on Foreign Relations and I have estimated that China accounted for 55 percent of Treasury purchases through London from mid 2006 to mid 2007 and 70 percent of Agency purchases through London and Hong Kong. We consequently estimate that China now holds roughly \$700 billion of Treasuries and \$600 billion of Agencies. That is

close to 10 percent of the United States GDP, and over 25 percent of China's GDP.

Table 2. Chinese holdings of US assets, as of August 2008

	Known US holdings	Estimated undercount	Estimated US holdings
Short-term bank deposits	35		35
Treasuries (including short-term)	541	130	670
Agencies (including short-term)	451	135	585
Corporate bonds	74	100	175
Equities	39	20	59
Total	1141	385	1525
Chinese foreign assets	2380		2380
US share (estimate)	48 percent		64 percent

China's holdings of risky US assets are also rising (whether mortgage-backed securities that lack an Agency guarantee, the bonds issued by non-financial firms like GM or the bonds issued by financial firms like Lehman or US equities). Total Chinese purchases of US corporate bonds over the last five years amount to approximately \$140b -- and that likely leaves out some corporate bonds bought through London.<sup>2</sup> SAFE is also thought to have about 5 percent of its portfolio in equities. Given its enormous size, this sum would imply that SAFE already has around \$100 billion of equities, including \$50 billion of US equities. Or rather it likely *had* about \$50 billion of US equities, since equities purchased in 2007 and early 2008 undoubtedly have fallen in value.

### **Reducing Risk**

In some ways, though, the most interesting story that emerges from the data isn't China's (modest) shift toward risky assets over the past two years. Rather, it is the dramatic shift out of risky assets – even slightly risky assets – over the past couple of months. During that time, the available data suggest that China has moved conservatively, investing almost entirely in Treasury bonds. In August (most current data) China is known to have added at least \$22.3 billion to its Treasury bond portfolio while reducing its exposure to other forms of US debt. Its Agency holdings – including short-term Agency paper – may have fallen by as much as \$10.4 billion. Moreover, New York Fed's custodial data indicates that foreign central banks, including SAFE, continue to shift away from Agencies toward Treasuries.<sup>3</sup>

The sharp fall in China's purchases of Agency bonds in August clearly contributed to the US Treasury's decision to recapitalize the Agencies. However, the Treasury's steps have failed to stabilize the market. Even after the "bailout," the interest rates

Fannie and Freddie have to pay to issue new debt remains relatively high, far higher than the interest rate the Treasury now pays. The current flight to safety by foreign central banks is rational from their point of view. In the current environment, central banks now want only the safest and most liquid assets, as the political cost of any loss far outweighs the gain from picking up a bit more yield. At the same time, foreign central banks sudden shift out of Agencies added to the instability in a key segment of the US market and by keeping the Agencies cost of funding up, it has kept mortgages higher than they otherwise would be, only worsening the distress.

### China Investment Corp.'s Portfolio

Both the size and composition of the CIC's foreign portfolio remain a mystery. The total amount of bonds that were sold to raise funds for the CIC are known – and it is known that \$67 billion of these funds were used to buy SAFE's stake in "Huijin" (the bank recapitalization vehicle created in 2003 when two of the state banks were recapitalized with PBoC reserves) rather than to buy foreign assets. Another \$23 billion has been used to recapitalize the China Development Bank and China Everbright Bank in December 2007 and the CIC recently announced that it would inject \$19 billion into the Agricultural bank of China. That leaves an estimated foreign portfolio of between \$100-110 billion.

The impact of the fall in China's purchases of Agencies is important for another reason. Such a move is the first concrete demonstration of China's financial leverage. It is often argued that China's large-scale purchases of US bonds aren't an effective political tool because China cannot scale back its purchases of US debt without hurting itself. This argument has a grain of truth. If China stopped buying US debt, Americans would not be able to buy as many Chinese products, and China's exports would suffer. But this argument also neglects two crucial points.

First, China's US portfolio is now so large and growing so fast that China can shape US markets by simply shifting from buying one kind of US financial asset to buying another kind of US asset. China didn't have to stop buying US debt or allow the RMB to appreciate against the dollar to push the US government to make its guarantee of the Agencies more explicit. All it had to do was shift from buying Agencies to buying Treasuries.

Second, China has interests other than just subsidizing its exports. Financially speaking, China would be better off if it allowed its currency to appreciate and stopped adding to its dollar portfolio. The longer China buys dollars (and euros), the more dollars it will accumulate, and the bigger loss it will eventually take on its foreign currency portfolio. China's leaders should know this; these losses are the financial price China has to pay for subsidizing its exports. But that doesn't mean it will accept losses on its dollar portfolio happily. It is likely that China will eventually push the US to adopt policies that maintain the value of China's investment in US securities. Creditors rarely see eye to eye with debtors. China's leaders are already starting to express concern about their potential exposure to the dollar – and frustration with US economic and financial policies.

Right now, the risk that China will reduce the priority it attaches to supporting its export sector and scale back its purchases of US bonds seems modest. The global slump is now causing real trouble of China's exporters and China's government seems committed to avoiding any further appreciation in the renminbi against the dollar. The third quarter data indicates a modest slowdown in the pace of China's reserve growth, as "speculative" inflows fell. But so long as any fall in China's exports is offset by a fall in imports, China's overall surplus will remain large. In the near-term, China's government consequently will still need to intervene to keep its currency from rising, and will continue to buy US bonds.

### **Excessive Dependence**

But in the long run, it is not in the interest of China to rely so heavily on the US market to support its growth. China's current export based growth strategy has reached its natural limit. US households simply cannot afford to keep on buying more Chinese goods even with access to subsidized credit from the government of China. Moreover, too much of China's savings has already been invested in the United States on terms that imply large future losses for China. Plausible estimates suggest that the real financial cost of China's exchange rate policy could now approach a stunning 5 percent of China's GDP. Rather than subsidizing US consumption, China should aim to put more of its savings to work in China.

Similarly, it is not in the long-run interest of the United States to rely so heavily on a single country's government for financing. Certainly that financing comes on very generous terms, but it also is the byproduct of an exchange rate policy that discourages investment in key sectors of the US economy. Cheap financing for Washington comes at the expense of more competition for the goods made in Milwaukee, Indianapolis and even Seattle. The US runs the risk that it could need China to add to its foreign exchange reserves more than China actually needs more reserves – an asymmetry that potentially gives China the ability to influence US policy. In the short-run, the first priority of the US government has to be to avoid a sharp fall in US demand that pushes the country into deeper recession. But in the long-run the United States shouldn't hope to return to a world where Chinese lending finances excessive US borrowing, but rather look to transition to a world in which more US investment is financed by the United States' own savings. ☹️

## **Notes**

<sup>1</sup> The June 2006 survey revised China's estimated holdings of Treasuries up by \$37 billion and its estimated holdings of Agencies up by \$50 billion; the June 2007 survey revised China's estimated holdings of Treasuries up by \$74 billion and its holdings of Agencies up by \$70 billion.

<sup>2</sup> The TIC flow data implied a \$32 billion increase in China's holdings of long-term US corporate bonds between June 2006 and June 2007. The survey data indicated a \$31 billion fall (from \$58.5 billion to \$27.6 billion). In effect, the survey shows smaller Chinese holdings of corporate bonds than would be implied by the monthly TIC data and far larger holdings of Treasury and Agency bonds than would be implied by the monthly TIC data.

<sup>3</sup> While the foreign central banks making use of the New York Fed's facilities are not disclosed, the size of China's holdings of Agencies in particular makes it mathematical certainty that China accounts for a large share of the custodial holdings.