



Sticky Situation: China and the Dollar

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Official figures show that at the end of May, total public debt outstanding was more than \$11.3 trillion – with 62% being owned by the public (versus intragovernmental holdings). 47% of the public debt is owned by foreigners - of which 24.3% is in the hands of the Central Bank of China. This equates to China owning the warrants for 801.5 billion U.S. dollars, up a staggering 58% year over year (YOY).

Much has been said about China holding so much of our debt, especially here in the U.S. by financial media and political leaders.

Most of the chatter relates to the Chinese's supposed tightening grip on American economic policy, which stems from the funding required to instill confidence and liquidity back into a shaky American economy. As told by the 58% YOY increase in Chinese ownership of Treasury Securities, much of the funding came from China.

It doesn't look like the U.S. will be calling a halt to the sale of treasuries and other securities anytime soon though. The Troubled Asset Relief Program (TARP), Federal Reserve rescue efforts, federal stimulus programs, and other financial and housing initiatives have already cost the country more than \$2.8 trillion. An additional \$8.2 trillion is set aside for further disbursements in these programs. These programs have pushed the debt over the aforementioned \$11 trillion mark, or 80% of GDP. With a quick glance at the national budget, we can predict the possibility of trillion dollar deficits for a few more years, at least.

Although a complex situation exists between China and U.S. Central Banks, the consequences for both countries are understood rather easily regarding this debt, future deficits, and the funding needed to support them.

For the U.S, a draining value in the dollar due to deficits piling onto what is already a mountain of debt will surely place considerable strain on the dollar's ability to remain in its role as the world's reserve currency. China's Zhou Xiaochuan, governor of the People's Bank of China, released a paper in March 2009 urging for a new international reserve currency, perhaps to be managed by the IMF. Such a currency would remain more stable in the long run, according to Mr. Zhou. It's quite obvious why he is pushing for this now. The continuing U.S. deficits should eventually lead to inflation, crimping the purchasing power of the dollar and therefore negatively affecting the massive Chinese

investment. The proposed currency would help to alleviate this risk of loss. For the U.S. though, *ceteris paribus*, this would likely slow the inflow of foreign funds into government securities needed to fund the predicted future deficits. In turn, we would expect rates to go up on these U.S. securities, pushing other rates within the U.S. upwards, and ultimately, the economy will have a lessened ability to grow.

However, in the short run it seems that the large and sharply increasing proportion of our debt in China's hands will be more of a problem for China than it is the U.S. This is so for two reasons. First, if the Chinese discontinue their funding of the American economic recovery and continuing deficits, they will surely record massive losses from their investment in American treasuries and the like due to dollar devaluation and probable inflation. And if there is no American economic recovery, China's booming and export driven economy will take a hit due to the inability to spend by the American consumer. The fitting summation to this sticky situation comes from Forbes' Gady Epstein, who writes, "It's the old debtor's aphorism, writ on a sovereign scale: If you owe China \$1 billion, it's your problem. If you owe China \$1 trillion, it's China's problem."

Sources:

Bureau of Economic Analysis, U.S. Department of the Treasury, White House.gov, Forbes, CNN, & CNBC.