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China’s wake-up call from Washington

Stephen S. Roach | Yale University | 25 October 2013

Yes, the United States dodged another bullet with a last-minute deal on the debt ceiling. But, with 90 days left to bridge the ideological and partisan divide before another crisis erupts, the fuse on America's debt bomb is getting shorter and shorter. As a dysfunctional US government peers into the abyss, China – America's largest foreign creditor – has much at stake.

It began so innocently. As recently as 2000, China owned only about $60 billion in US Treasuries, or roughly 2% of the outstanding US debt of $3.3 trillion held by the public. But then both countries upped the ante on America's fiscal profligacy. US debt exploded to nearly $12 trillion ($16.7 trillion if intragovernmental holdings are included). And China's share of America’s publicly-held debt overhang increased more than five-fold, to nearly 11% ($1.3 trillion) by July 2013. Along with roughly $700 billion in Chinese holdings of US agency debt (Fannie Mae and Freddie Mac), China's total $2 trillion exposure to US government and quasi-government securities is massive by any standard.

China's seemingly open-ended purchases of US government debt are at the heart of a web of codependency that binds the two economies. China does not buy Treasuries out of benevolence, or because it looks to America as a shining example of wealth and prosperity. It certainly is not attracted by the return and seemingly riskless security of US government paper – both of which are much in play in an era of zero interest rates and mounting concerns about default. Nor is sympathy at work; China does not buy Treasuries because it wants to temper the pain of America's fiscal brinkmanship.

China buys Treasuries because they suit its currency policy and the export-led growth that it has relied on over the past 33 years. As a surplus saver, China has run large current-account surpluses since 1994, accumulating a massive portfolio of foreign-exchange reserves that now stands at almost $3.7 trillion.

China has recycled about 60% of these reserves back into dollar-denominated US government securities, because it wants to limit any appreciation of the renminbi against the world's benchmark currency. If China bought fewer dollars, the renminbi's exchange rate – up 35% against the dollar since mid-2005 – would strengthen more sharply than it already has, jeopardising competiveness and export-led growth.

This arrangement fits America's needs like a glove. Given its extraordinary shortfall of domestic saving, the US runs chronic current-account deficits and relies on foreign investors to fill the funding void. US politicians take this for granted as a special privilege bestowed by the dollar's position as the world's major reserve currency. When queried about America's dependence on foreign lenders, they often smugly retort, "Where else would they go?" I have heard that line many times when I have testified before the US Congress.

Of course, America benefits from China's outward-facing growth model in many other ways, as well. China's purchases of Treasuries help hold down US interest rates – possibly by as much as one percentage point – which provides broad support to other asset markets, such as equities and real estate, whose valuation depends to some extent on Chinese-subsidized US interest rates. And, of course, hard-pressed middle-class American consumers benefit hugely from low-cost Chinese imports – the Walmart effect – that enable them to stretch their budgets in an era of unrelenting pressure on jobs and real incomes.

For more than 20 years, this mutually beneficial codependency has served both countries well in compensating for their inherent saving imbalances while satisfying their respective growth agendas. But here the past should not be viewed as prologue. A seismic shift is at hand, and America's recent fiscal follies may well be the tipping point.

China has made a conscious strategic decision to alter its growth strategy. Its 12th Five-Year Plan, enacted in March 2011, lays out a broad framework for a more balanced growth model that relies increasingly on domestic private consumption. These plans are about to be put into action. An important meeting in November – the Third Plenum of the Central Committee of the 18th Chinese Communist Party Congress – will provide a major test of the new leadership team's commitment to a detailed agenda of reforms and policies that will be required to achieve this shift.

The debt-ceiling debacle has sent a clear message to China and it comes in conjunction with other warning signs. Post-crisis sluggishness in US aggregate demand – especially consumer demand – is likely to persist, denying Chinese exporters the support they need from their largest foreign market. US-led China bashing (a bipartisan blame game that reached new heights in the 2012 political cycle) remains a real threat. And now the safety and security of US debt are at risk. Economic alarms rarely ring so loudly. The time has come for China to respond with equal clarity.

Rebalancing is China's only option. Several internal factors – excess resource consumption, environmental degradation, and mounting income inequalities – are calling the old model into question, while a broad constellation of US-centric external forces also attests to the urgent need for realignment.

With rebalancing will come a decline in China's surplus saving, much slower accumulation of foreign-exchange reserves, and a concomitant reduction in its seemingly voracious demand for dollar-denominated assets. Curtailing purchases of US Treasuries is a perfectly logical outgrowth of this process. Long dependent on China to finesse its fiscal problems, America may now have to pay a much steeper price to secure external capital.

Recently, Chinese commentators have provocatively referred to the inevitability of a "de-Americanised world." For China, this is not a power race. It should be seen as more of a conscious strategy to do what is right for China as it confronts its own daunting growth and development imperatives in the coming years.

The US will find it equally urgent to come to grips with a very different China. Codependency was never a sustainable strategy for either side. China just happens to have understood this first. The days of its open-ended buying of Treasuries will soon come to an end.

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