

CHINA, JAPAN AND OUR DEBT

Will Other Countries Keep Buying Our Treasuries?



Source: *The Economist*, www.economist.com

If China and Japan change their minds, could the United States have a problem? Since 1980, the U.S. has imported more than it has exported.¹ The U.S. makes up for this trade deficit by issuing Treasury bonds and other debt instruments. Foreign governments have long lined up to buy them.

China holds almost \$800 billion of U.S. Treasuries. That's the April 2009 figure from the U.S. Treasury (at this moment, the most recent data). In addition, Japan has \$686 billion in Treasuries. Hong Kong has \$81 billion, Taiwan \$78 billion, Singapore \$40 billion, India \$39 billion, and South Korea \$35 billion. Away from Asia, Great Britain holds \$153 billion, Russia holds \$137 billion, and Brazil holds \$126 billion.² U.S. Treasury bonds offer these institutional investors some stability in uncertain times.

Are China and Japan wary of buying more? Earlier in the decade, China, Japan and other nations readily bought Treasuries. From 2004-2008, China spent as much as 14% of its GDP on the purchase of foreign debt - mostly American debt.³

What happened as a result? China, Japan and other creditor countries got a nice return on their investment and a strong export market. We got to buy inexpensive imports. This kept the dollar strong and interest rates low.

Now we have two problems that could potentially sour this relationship. The economies of China, Japan and other countries have suffered along with ours in the global recession. Moreover, the U.S. has run up a huge budget deficit to accompany its trade deficit. Our President is on record as saying that we may have trillion-dollar deficits for "years to come."

Under these conditions, China and Japan are naturally getting leery of holding so much American debt (especially when the Federal Reserve is printing money to buy it). China needs to pay for its own \$600 billion stimulus package, and Japan announced a \$154 billion stimulus in April. Tax revenues in both economies have declined with the recession. Government regulators in China have ordered banks to direct money this year to local governments and small- and

medium-sized businesses. All this means China and Japan aren't as eager for dollars and Treasuries as they were a few years ago.^{3,4}

What if other nations stop buying our debt? There are three potential side effects. One, interest rates would likely increase as there would be fewer buyers for Treasuries. Two, the dollar could weaken. Three, long-term bond prices could fall.

Voices on the fringe worry about a scenario in which the central banks of China, Japan and other nations jettison dollars en masse or abruptly quit buying U.S. debt. Realistically, the odds of something like this happening are slim. These countries would have nothing to gain by stifling America's chances for economic recovery, and these decisions would greatly harm the world economy.



Now for some good news. In May, our trade deficit fell to its lowest level since November 1999. It shrank 9.8% in May from April levels, defying analysts' expectations – and offering a hint of economic recovery. Our deficit with China increased by \$4.4 billion for May, but the 2009 increase is 12.6% under last year's pace. The U.S. deficit with Japan reduced to its lowest level in more than 20 years last month.⁵

More good news. Domestic and foreign demand for Treasuries is still strong – in its auction in the first full week of July, the Treasury quickly sold \$19 billion of 10-year notes, with Treasury yields hitting 6½-week lows.⁶ At least in the short term, it appears the government doesn't have to struggle for buyers to fund its reforms and rescue efforts.

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Citations.

¹ moneycentral.msn.com/content/invest/extra/P140049.asp [1/5/06]

² treas.gov/tic/mfh.txt [6/15/09]

³ nytimes.com/2009/01/08/business/worldbusiness/08yuan.html [1/8/09]

⁴ nytimes.com/2009/04/09/business/global/09yen.html [4/9/09]

⁵ finance.yahoo.com/news/May-trade-deficit-apf-2840686452.html?x=0&sec=topStories&pos=6&asset=&ccode= [7/10/09]

⁶ forbes.com/feeds/reuters/2009/07/08/2009-07-08T205823Z_01_N08405527_RTRIDST_0_MARKETS-GLOBAL-WRAPUP-6.html [7/8/09]