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Learning to Float

Despite shaky economic fundamentals, US government securities are usually regarded as a safe haven. Whenever a crisis erupts, the value of US Treasury bonds gets a boost. Indeed, US Treasuries were among the few assets that did not decline during the global financial crisis in 2008-2009.

But the safe-haven status of US government securities is an illusion. They are safe only in the sense that no one can stop the Federal Reserve from operating its printing presses at full speed.

The market value of Treasuries depends on a wide range of factors. Now it is essentially sustained by a Ponzi scheme, with the Fed's policy of "quantitative easing" keeping the price of Treasuries artificially high. But, at end of the day, no currency can defy the laws of economic gravity. The market price of Treasuries eventually will fall to levels dictated by US economic fundamentals.

For decades, China has been investing its vast savings abroad, waiting for greater efficiency in domestic investment allocation before starting to dissave. China usually holds US Treasuries to maturity and re-invests the principal and proceeds. What matters is not variations in the book value of these reserves, but rather their real value in terms of purchasing power when China decides to cash in.

We do not know what the People’s Bank of China (PBOC, the central bank) is doing at the moment in the bond market. What we do know is that China should have begun exiting gradually from US government securities long ago.

But, according to US Treasury data, China’s holdings of US government securities totaled $1.16 trillion at the end of 2010, accounting for roughly 60% of the overall increase in foreign official holdings of US government debt. China’s holdings of US Treasuries increased by $351 billion between June 2009 and June 2010 alone, the largest jump on record.

The accuracy of these data is debatable. But they seem to show that, despite sharper rhetoric in Sino-US relations, China has continued lending to the US in order to keep its export machine going and avoid booking large foreign-exchange losses.

It may be too late to do anything about China’s existing stock of US treasuries without causing a serious political and financial backlash. But China should at least stop increasing its holdings. Since 2009, China’s trade surplus has dropped significantly, which many in China hail as progress in rebalancing. Yet China's 2010 trade surplus was still $183 billion; its current-account surplus soared 25% from 2009, to $306.2 billion; and its balance-of-payments surplus last year totaled more than $470 billion - the bulk of which must have been invested in new holdings of foreign-exchange reserves.

Needless to say, these surpluses reflect a gross misallocation of resources. Above a certain limit, China’s stockpiles of US treasury bonds imply welfare losses, not to mention the capital losses that the country almost certainly will suffer.

Is China destined to see the value of its savings evaporate? Given the trade and current-account surpluses, the PBOC must intervene in currency markets, buying the dollar and selling renminbi, to prevent - or moderate - the appreciation of the renminbi exchange rate. But such interventions inevitably translate into more holdings of US government securities.

To stop this accumulation of foreign-exchange reserves, and thus minimize China's welfare and capital losses, the simplest solution would be for the PBOC to call a halt to intervention. But this implies that China must allow the renminbi to float freely, and thus to appreciate. But nobody knows by how much. China's official position is that the renminbi is not seriously undervalued. In that case, the government should not fear the end of intervention.

Indeed, some Chinese authorities also maintain that renminbi appreciation would have no significant impact on China's trade balance because they believe that China's trade surplus is a reflection of excess saving and hence has nothing to do with the exchange rate. If so, there would be no need for China to worry about even a large jump in the renminbi's exchange rate.

The true risk lies in the possibility that the renminbi is significantly undervalued and that appreciation would have a major impact on China's trade balance. In that case, China would have to accept an export slowdown and an increase in unemployment in order to avoid huge capital losses on its dollar reserves.

Currently, the government is trying to slow the GDP growth rate, and job shortages are emerging in coastal areas. With the fiscal position still strong, the government should be able to help enterprises and workers that suffer undue pain from the renminbi's appreciation.

Moreover, while exchange-rate policy is not an instrument for dealing with

China’s domestic inflation, renminbi appreciation would certainly help the government meet its goal of keeping the annual rate below 4% in 2011. Indeed, the increase in foreign-exchange reserves has been the single most important monetary source of inflation, as the PBOC has run into trouble sterilizing the inflows. The end of intervention in currency markets would allow the PBOC to shrug off the burden of sterilization and concentrate on fighting inflation.

Ending central-bank intervention in currency markets is a complex issue. The devil is in the details. But, under any circumstances, the economic and welfare costs of China’s slow pace in adjusting the renminbi’s exchange-rate are too high and will increase by the day. It is time for China to seriously consider allowing the renminbi to float freely, while reserving the right to intervene when it must, and tighten the management of cross-border capital flows (permissible under last November’s G-20 agreements).