

# Thursday, July 24, 2008

## [Why US debt makes the country vulnerable.](#)

The US government now has \$2061 billion of Treasury Bills in circulation. This is effectively the size of the loan it has taken from the rest of the world in order to finance its economy and is one of the reasons that the US Dollar has depreciated so significantly against many other currencies over the last few years. Since 2001 the US Dollar has depreciated 43% against the Swiss Franc and 47% against the Euro. This depreciation has been fairly orderly but there are increasingly important reasons why a disorderly depreciation, or even a run on the currency, could occur.

The largest holder of T-bills is Japan with \$592 billion, closely followed by China with \$502 billion and the OPEC members who between them officially have \$154 billion. However, a lot of OPEC members also own T-bills via proxy that are held in the UK. The high oil price has seen the foreign exchange reserves of these countries swelled with Dollars as oil is primarily priced in US Dollars. China has accumulated their holdings due to the huge levels of trade that are carried on with the rest of the world using Dollars. Japan has long been a keen buyer of T-bills but has recently started to reduce its holdings (by 3.6% in the last year). Asian central banks don't publicise the allocation of their currency reserves but they hold about \$4.35 trillion in total foreign exchange reserves and about 70% of these are thought to be Dollar-denominated. US Dollars and Dollar-denominated assets are held in a wide range of foreign countries, some of whom have strained political relations with the US due to the aggressive foreign policy of the Bush administration and one has to wonder how far they will bend to the will of a financially weak and economically exposed America.

There are several reasons why the US Dollar is exposed to geopolitical and investment risk in a way that hasn't been seen before:

- 1) Several countries are now pursuing a policy of diversification away from the US Dollar in their foreign exchange reserves as they are still worried about further depreciation due to the declining economic environment in the US. The Euro is a potential beneficiary or a basket of currencies could be adopted. If everyone starts diversifying at the same time there is the risk of flight from Dollar assets that begins to become obvious to markets and which could cause other investors to panic. Whilst sovereign wealth funds are usually slow to act, they have indicated greater interest in investments in Europe and emerging markets as a way of diversifying their currency allocation as well as their asset allocations.

- 2) There is talk of the US losing its top investment grade rating and if this were to happen there could be a crisis of confidence in the Dollar. A downgrade would require the US to offer higher interest rates, which in turn is not good for the economy and could cause further Dollar weakness. The US has held a triple-A rating since 1917 but healthcare and social security costs are rising with no sign of a solution to their spiralling costs. The cost of financing military excursions in Afghanistan and Iraq also adds to the problem. America has been spending beyond its means for some time (hence the huge volume of T-bills in circulation) but there is a strong possibility that this strategy may have serious repercussions one day.

3) Several middle-eastern and Asian countries have pegged their currencies to the US Dollar and have had to lower their base rates in line with US rates, in spite of the fact that they are experiencing very high levels of inflation. Qatar is struggling with 14% inflation, Egypt 19%, Dubai 20%, Saudi 10%, UAE 11%. They are not suffering from the same economic woes as the US so interest rates of 2% are totally inappropriate. Middle-eastern countries have been forced to lower rates just as their economies are booming on the back of oil receipts and domestic investment is running at record levels. This divergence in economic fortunes has placed great strains on the Dollar peg and there is a chance that some countries might have to break it at some point, which could be extremely Dollar-negative.

4) The size of its outstanding debt to the rest of the world makes the US vulnerable to pressure in global political matters. If, for example, China wanted to have its way on an important political issue, it could infer that it was going to reduce its Dollar holdings due to lack of confidence in the currency. This kind of declaration would have hugely negative ramifications for the Dollar and the US economy and is something the US would be keen to avoid.

It is this fourth point that I wish to expand on. China is often seen as the main threat to US domination in global politics due to its size, its economy and its military might. It now has a major bargaining advantage in its creditor status. Since China's rise to prominence as a global economic power, its partial embrace of capitalist culture and its accession to the World Trade Organisation there hasn't really been a significant dispute with the US. But what if this was to change one day? In the same way that Russia has become more confident and more belligerent as its economic wealth has grown, China could also adopt a more aggressive stance towards the US.

In some ways the economic strength of the US and its influence on the world stage has been sold out from underneath it by the sale of so many Treasury bills. A country such as China, which holds 19% of all the T-bills in circulation, might be able to dictate terms to the US or else it could threaten to sell off its holdings under the auspices of diversification or lack of confidence. Whilst this would mean that the value of all China's Dollar-denominated foreign reserves were pummelled, it would ultimately survive. However, there would be a run on the US Dollar and it would decimate the US economic system. In one single bound China could overtake the US as the world's most important economy and as the world's premier superpower.

If China was to sell its US Dollar holdings at an accelerated rate then the value of the Dollar would collapse and interest rates would be forced up in order to support the currency. High interest rates would almost certainly send the US into a severe recession. It would also likely lose its triple-A credit rating which would exacerbate the problem. A stable currency is essential for any country to attract foreign investment and the Dollar has been propped up for a long time by the continued purchases of T-bills by overseas investors, particularly China due to the size of its holdings. It currently requires \$2 billion a day to finance the current account and if sovereign wealth funds stopped buying Dollars the deficit could balloon to unmanageable proportions. America's role as the greatest economic power in the world would be at an end.

Other holders of Dollar-denominated assets such as Japan and the OPEC members would also suffer and they would certainly condemn China for taking such action but are their concerns enough for China to pass up the chance of moving up the rankings in the global economy? Wars have been started for less.

Whilst the chance of an economic attack on the US by China as described above might be considered fantasy, the fact remains that the US has put itself in a position where it is theoretically possible that such a strategy could be carried out and where the very hint of a threat by the Chinese could be extremely damaging. Sino-US relations have never been particularly friendly and the two countries have traditionally been seen as opponents, if not enemies. Maybe the struggle between Communism and Capitalism hasn't completely disappeared after all and the Chinese have been merely biding their time.

The US has been quite vocal about the way it thinks China should manage its currency but it is not really in a position to dish out advice on a subject in which it is clearly not an expert. The current Bush administration continues to officially support a strong Dollar policy but the reality is somewhat different and they are kidding no-one. Either the US has no control over its own currency or the huge depreciation in the value of the Dollar was what they wanted all along. However, today the US has clearly lost a large degree of control over its currency, and by association its economy, because it has put itself in the position of debtor to China (and to other countries) and this makes the US a riskier place to invest than is widely perceived, regardless of its current credit rating. A rapid sale of US treasuries by China might seem like a black swan event but it is one that is theoretically possible and which can be foreseen. If it ever occurs then you don't want to be holding US Dollars. Even without any action on the part of foreign holders of US Treasuries, the balance of power has certainly changed and the US has placed itself in a vulnerable position.