Confluence
INVESTMENT MANAGEMENT

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Geopolitical Report
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China's Foreign Reserves: Part III

This week, we will conclude our study on China's foreign reserves. In Part I, we discussed the evolution of foreign reserves from gold to the dollar, with a historical focus. In Part II, we used the macroeconomic saving identity to analyze the economic relationship between China and the U.S. This week, using this analysis, we will discuss the likelihood that China will "dump" its Treasuries and the potential repercussions if it were to do so. From there, we will examine the impact of such a decision by China to reallocate its reserves. Finally, we will conclude with market ramifications.

What if China decides to dump its reserves?
So, finally, we come to the issue at hand. Are China's foreign reserves a real threat to the U.S. economy? Are the reserves a viable financial weapon? China occasionally suggests they are.[1] However, a weapon is only credible if the blowback isn't significant. It appears that the costs to China of dumping its U.S. Treasury bond positions would be considerable.

What would happen to the value of China's reserves? A common problem with holding concentrated positions is retaining value while exiting the position. If China began aggressively selling its position, the value of its reserves would decline as well. If yields rose by 100 bps, to 4%, we estimate the yearly return would drop by approximately 7.9%.[2] China's total foreign reserves are around $3.2 trillion; as mentioned in Part II, it's a state secret as to the allocation but if we assume Treasuries represent 70% then a 7.9% decline would cause a capital loss of $152 bn. Obviously, a 10-year T-note rate of 4% would likely trigger a U.S. recession but the costs to China would be significant as well. It is also important to note that this calculation doesn't take into account the impact on the dollar's exchange rate. But, mostly certainly, the dollar would depreciate, causing even greater losses to China's dollar foreign reserve holdings.

Where would the money go? If China wanted to move away from Treasuries, what other markets could absorb the funds? Although Greece or Italy might welcome China's inflows, China would probably be reluctant to put significant reserves into those markets. China's main principles for administration of foreign reserves are "security, liquidity and increases in value, among which security is the primary principle."[3] The Eurozone doesn't have a full faith and credit instrument, meaning China would have to buy individual nation securities. Japan's market is fairly deep (central government debt is around $11 trillion), but yields are low and the risk of Japanese debt is elevated with government

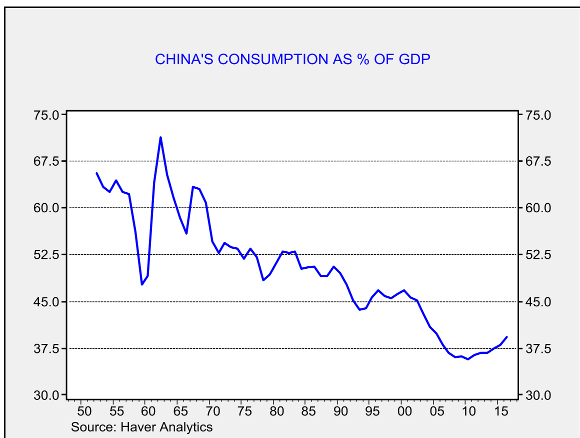
[1] https://www.telegraph.co.uk/finance/markets/2813630/China-threatens-nuclear-option-of-dollar-sales.html

[2] This is calculated with a regression of total return on the 10-year T-note against the (a) yearly change in 10-year yields, and (b) the level of interest rates on the 10-year T-note.

[3] China's State Administration of Foreign Exchange, FAQs on Foreign Exchange Reserves, cited in: https://fas.org/sgp/crs/row/RL34314.pdf

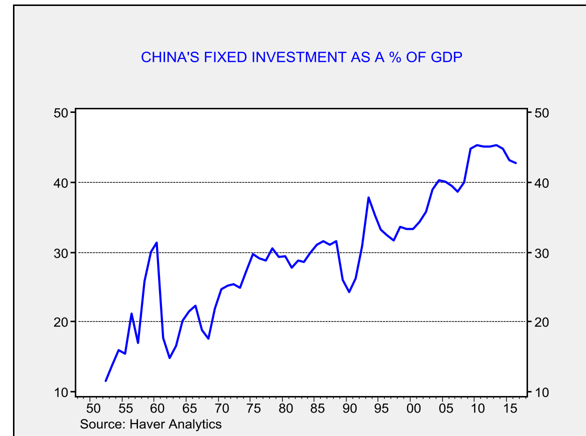
debt over 200% of GDP. In theory, China could buy commodities, but the risk in owning commodities is obviously high; grain can rot, oil can burn and although gold has been prized for centuries because it doesn't deteriorate it would be hard to move a significant amount of reserves into gold. The World Gold Council estimates the total value of all the gold ever mined at $7.8 trillion.[4] To shift just the estimated U.S. Treasury portion would mean China would have to acquire a bit more than a quarter of the world's known gold. Obviously, this would send the price of gold soaring and, once acquired, China would face the same problem it has now—if it wanted to sell the gold, the price would likely plummet. And, by owning gold, China would earn no interest on its foreign reserves.

What would China's economy do going forward? China's development model rests on excess saving. Dumping reserves would only work if it decided to restructure its economy. Although it wants to do this, the progress on this front has been slow.



This chart shows China's consumption relative to GDP. Since the late 1970s, when China emerged from its isolation under Mao, it has constrained consumption to supply saving for investment. The chart below shows China's fixed investment relative to GDP. It has moved in the opposite direction.

The restructuring would require less investment and more consumption, which would have significant political effects as the wealthy in China have benefited from the heavy investment bias and would resist attempts to change the economy's direction.[5]



Perhaps the greatest danger from China's dollar reserves would be a change in investing patterns. China could sell Treasuries with the intent of buying other American assets. Japan did something similar in the late 1980s when it purchased "trophy" properties such as Pebble Beach.[6] We doubt China would be interested in such trophy purchases; instead, it might try to buy U.S. technology firms in a bid to bolster its technological prowess under the "Made in China 2025"[7] program. We note the Trump

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[4]https://www.forbes.com/sites/oliviergarret/2017/10/26/all-the-reasons-cryptocurrencies-will-never-replace-gold-as-your-financial-hedge/#3e5ed2b8380e

[5] We suspect Chairman Xi's steady accumulation of power is designed to give him the authority to make these painful adjustments.

[6]https://www.nytimes.com/1990/09/07/business/japanese-buy-pebble-beach-golf-course.html

[7] https://www.washingtonpost.com/news/monkey-cage/wp/2018/05/03/what-is-made-in-china-2025-

administration has become quite vigilant in blocking such efforts.[8]

China could use dollar assets to make investments as part of its "one belt, one road" project. However, this would require shifting from a safe investment to a much more risky investment, violating its aforementioned goals for foreign reserves.

Ramifications

In the end, we do expect China to slow its purchases of Treasuries going forward because Chairman Xi wants to restructure China's economy.

This restructuring will lead to somewhat higher U.S. interest rates because the inverse of fewer flows is a narrower trade deficit. That will boost the U.S. economy and employment but will also lead to higher inflation pressures. However, in the current political environment, such an outcome would likely be welcomed. It could also lead to a lower multiple for equities, but should support strong earnings.

This shift is part of the reason we believe the secular bull market in long-duration fixed income is coming to an end because the U.S. is in retreat from globalization. That will likely mean a smaller trade deficit and faster growth, but higher inflation.

Overall, the worry about China dumping its reserves is probably overdone. It's important to remember that the Chinese didn't buy Treasuries because they liked us or wanted to help the U.S. They did so because they wanted to build their economy on investment and saving and the only nation on earth that was willing to accept the resulting trade flows was the United States. China's foreign reserve policy was a consequence of its development model; in other words, the cost to China for low unemployment is $3.2 trillion of foreign reserves.

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and-why-is-it-a-threat-to-trumps-trade-goals/?utm_term=.05b5dc231fb4

[8] https://www.nytimes.com/2018/04/16/technology/chinese-tech-company-blocked-from-buying-american-components.html

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