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America’s Bond Market Blues

By Editor Test *Thu, Sep 19, 2013*

"For China, the benefits of holding large quantities of US dollars no longer outweigh the risks, so it must begin to reduce the share of US securities in its foreign-exchange reserves," writes a researcher at the China Macroeconomic Research Platform.

The market for United States Treasury securities is one of the world’s largest and most active debt markets, providing investors with a secure stock of value and a reliable income stream, while helping to lower the US government’s debt-servicing costs.

But, according to the US Treasury Department, overseas investors sold a record $54.5 billion in long-term US debt in April of this year, with China slashing its holdings by $5.4 billion. This dumping of US government debt by foreign investors heralds the end of an era of cheap financing for the US.

As it stands, the US government holds roughly 40% of its debt through the Federal Reserve and government agencies like the Social Security Trust Fund, while American and foreign investors hold 30% each. Emerging economies – many of which use large trade surpluses to drive GDP growth and supplement their foreign-exchange reserves with the resulting capital inflows – are leading buyers of US debt.

Over the last decade, these countries’ foreign-exchange reserves have swelled from $750 billion to $6.3 trillion – more than 50% of the global total – providing a major source of financing that has effectively suppressed long-term US borrowing costs. With yields on US ten-year bonds falling by 45% annually, on average, from 2000 to 2012, the US was able to finance its debt on exceptionally favorable terms.

But the ongoing depreciation of the US dollar – which has fallen by almost half since the Bretton Woods system collapsed in 1971 – together with the rising volume of US government debt, undermines the purchasing power of investors in US government securities. This diminishes the value of these countries’ foreign-exchange reserves, endangers their fiscal and exchange-rate policies, and undermines their financial security.

Nowhere is this more problematic than in China, which, despite the recent sell-off, remains by far America’s largest foreign creditor, accounting for more than 22% of America’s foreign-held. Chinese demand for Treasuries has enabled the US to increase its government debt almost threefold over the last decade, from roughly $6 trillion to $16.7 trillion. This, in turn, has fueled a roughly 28% annual expansion in China’s foreign-exchange reserves.

China’s purchases of American debt effectively transferred the official reserves gained via China’s trade surplus back to the US market. In early 2000, China held only $71.4 billion of US debt and accounted for 8% of total foreign investment in the US. By the end of 2012, this figure had reached $1.2 trillion, accounting for 22% of inward foreign investment.

But China’s reserves have long suffered as a result, yielding only 2% on US ten-year bonds, when they should be yielding 3-5%. Meanwhile, outward foreign direct investment yields 20% annually, on average.

So, whereas China’s $3 trillion in foreign-exchange reserves will yield only about $100 billion annually, its $1.53 trillion in foreign direct investment could bring in annual returns totaling around $300 billion.

Despite such low returns, China has continued to invest its reserves in the US, largely owing to the inability of its own under-developed financial market to generate a sufficient supply of safe assets. In the first four months of this year, China added $44.3 billion of US Treasury securities to its reserves, meaning that such debt now accounts for 38% of China’s total foreign-exchange reserves. But the growing risk associated with US Treasury bonds should prompt China to reduce its holdings of US debt.

The US Federal Reserve’s announcement in May that it may wind down its quantitative easing (QE) program – that is, large-scale purchases of long-term financial assets – by the end of this year has sparked fears of a 1994-style bond-market collapse. Concerns that a sharp rise in interest rates will cause the value of bond portfolios to plummet have contributed to the recent wave of foreign investors dumping US debt – a trend that is likely to continue to the extent that the Fed follows through on its exit from QE.

Yields on ten-year U.S. bonds are now 2.94%, a 58% increase since the first quarter of this year, causing the interest-rate gap between two- and ten-year bonds to widen to 248 basis points. According to the Congressional Budget Office, the yield rate on ten-year bonds will continue to rise, reaching 5% by 2019 and remaining at or above that level for the next five years. While it is unlikely that this will lead to a 1994-style disaster, especially given that the current yield rate remains very low by historical standards, it will destabilize the US debt market.

For China, the benefits of holding large quantities of US dollars no longer outweigh the risks, so it must begin to reduce the share of US securities in its foreign-exchange reserves. Given that China will reduce the overall size of its reserves as its population ages and its economic-growth model shifts toward domestic consumption, a substantial sell-off of US debt is inevitable – and, with it, a large and permanent increase in America’s financing costs.