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Power and Financial Interdependence

Brad SETSER

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Abstract

The link between financial self-reliance and geopolitical power has long been debated. The unbalanced Sino-American trade relationship has created asymmetric financial ties which generate potential sources of leverage for both parties and will not quickly disappear. Absent a clarifying major crisis, it will be difficult to definitively determine which party has greater leverage.

Many in the United States (US) are concerned about indebtedness to its primary strategic rival, and the risks posed by a sudden Chinese withdrawal from US financial markets. US policymakers actively sought to encourage China's top leadership not to withdraw financing from the market for US Agency securities in the run-up to the global financial crisis.

Yet China also sees risks in this unbalanced financial relationship. Chinese policymakers have expressed concern about the domestic political consequences of losses on either their Treasury or Agency holdings and actively have sought to diversify China's reserves – including by substituting the risk of lending to developing economies for the visibility associated with large holdings of Treasuries in US custodians. China increasingly worries that its dollar holdings and the dollar's global role increase its vulnerability to potential financial sanctions.

Both parties thus worry about the possibility that financial interdependence can be weaponized yet find it hard to extricate themselves from the inevitability of financial interdependence absent a clean break from an entrenched pattern of trade imbalances.

Résumé

Le rapport entre autonomie financière et puissance géopolitique fait depuis longtemps débat. Le déséquilibre des relations commerciales sino-américaines a créé des liens financiers asymétriques qui ont doté les deux parties de moyens de pression potentiels et qui s'annoncent durables. En l'absence d'une crise majeure qui clarifie la situation, il est difficile de déterminer avec certitude laquelle des deux parties dispose de la plus grande marge de manœuvre.

Aux États-Unis, beaucoup s'inquiètent de l'endettement du pays auprès de son principal adversaire stratégique et des risques posés par un retrait soudain de la Chine des marchés financiers américains. Les responsables politiques américains ont activement encouragé les dirigeants chinois à ne pas retirer leurs financements du marché des titres d'agences américains au cours de la période qui a précédé la crise financière mondiale.

Côté chinois, on perçoit aussi des risques dans cette relation financière asymétrique. Les responsables politiques chinois ont exprimé leur inquiétude quant aux conséquences politiques nationales des pertes sur leurs avoirs en bons du Trésor ou en titres d'agences, et ont résolument cherché à diversifier les réserves de la Chine, notamment en préférant l'octroi risqué de prêts aux économies en développement à la visibilité qu'implique la possession d'importants avoirs en bons du Trésor auprès de dépositaires américains. La Chine craint de plus en plus que ses avoirs en dollars et le rôle mondial du dollar n'augmentent sa vulnérabilité face à d'éventuelles sanctions financières.

Les deux parties s'inquiètent donc que l'interdépendance financière puisse être utilisée comme une arme stratégique, tout en ayant du mal à échapper à l'inéluctabilité de cette interdépendance financière en l'absence de rupture avec un modèle établi de déséquilibres commerciaux.

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Introduction

The link between financial self-reliance and a country's geopolitical autonomy has been long debated and lacks a clear answer. Charles de Gaulle believed that financial independence was critical to a country's strategic autonomy: "Without financial independence, there is no such thing as independence."[1] De Gaulle, advised by Valéry Giscard d'Estaing, pursued a policy of fiscal rigor that generated budget surpluses and reduced France's public debt – and maintained a fiscal and monetary mix that generated balance of payments surpluses and the buildup of France's foreign exchange reserves.

De Gaulle's views map to the historical experience of the late nineteenth century, when the balance payments difficulties in the Ottoman Empire, as well as the personal financial difficulties of Egypt's Khedive, created the conditions for Britain to gain effective control over strategic assets – notably the Suez Canal. His conviction was no doubt strengthened by the 1956 Suez Crisis when France's partner (Britain) withdrew its troops in the face of the threat of losing US financing and forced devaluation of the pound.

Yet British views on the relationship between debt and power are complex. Historian Niall Ferguson argues that Britain's twentieth-century success stemmed in part from the exceptional capacity of the British state to borrow and, thus, to spread the cost of the Napoleonic Wars over time. Rather than hindering Britain's rise to global power, Britain's ability to support a high level of debt allowed it to regain global primacy after the American Revolution.[2]

In the current context, the debate over the relationship between different definitions of financial strength and political and strategic power emerges most clearly out of a discussion of the complex financial relationship between the world's rising power, China, and the leading incumbent power, the United States. After the Asian financial crisis, China's leadership seems to have concluded that China needs a strong external position in order to maintain full domestic policy autonomy – and believes a strong external position creates additional tools to build China's global influence. Current account surpluses are viewed as evidence of national export strength, and large reserves have generally been viewed as a sign of financial strength. Beijing's mandarins generally believe capital should flow primarily through the state financial system, not move through the world unshackled.

1. M. Avaro, "A Gold Battle? De Gaulle and the Dollar Hegemony during the Bretton Woods Era", Philadelphia, University of Pennsylvania, 2022.

2. N. Ferguson, *The Cash Nexus: Money and Power in the Modern World*, New York: Basic Books, 2002.

Beijing also admires the financial power – or at least the sanctioning power – created by the dollar's global use, and its desire to maintain a large stock of foreign reserves has been balanced by concerns about the safety of its large holdings of dollar bonds – Treasuries, but also Agencies. China's effort to develop the capacity to protect itself from US sanctions has helped to motivate half steps that seek to broaden the global use of the renminbi. Yet such efforts have often been hampered by China's even stronger desire to maintain tight control of its currency and cross-border flows.

US views on the question are equally conflicted. There continues to be concern about the impact that Chinese sales could have on the stability of the Treasury market. The threat of such sales could conceivably limit the United States' own policy choices: Hillary Clinton famously asked: "How can the US enforce its trade law against its banker?"[3] While President Trump wasn't constrained by such fears, the George W. Bush Administration did worry that Chinese sales could disrupt America's response to its 2008 financial crisis. While the scale of Chinese inflows has slowed after 2014, many American policymakers – and bankers – worry that reliance on the "balance of financial terror" for both financial and strategic stability flirts with disaster.

Yet concerns about excessive reliance on China for financing sit uncomfortably with the common, if somewhat unsubstantiated, view that the dollar's global role – specifically as the dominant reserve currency – is central to the United States' continued global power. Global demand for dollar reserves, according to many, allows the US to sustain the fiscal deficits that allow it to maintain the American global footprint without unacceptable levels of domestic taxation.[4] The global role of the dollar creates demand for both dollar reserve assets and for Treasuries – and sustaining that demand is a critical interest of the US – even if that means growing indebtedness to its leading strategic rival.

The debate on whether external debt is a strategic vulnerability or a strategic asset is of particular importance in the current era. Geopolitical risks have returned; "history" hasn't faded into a flat world. Witness Russia's invasion of Ukraine, the interruption of pipeline gas flows to the European Union, China's "no limits" partnership with Russia, and serious discussion of crisis scenarios in the Taiwan Strait. Yet Economic fragmentation can only go so far when the world's two big geopolitical blocks have an unbalanced trade relationship. The US external debt, now on net about 50% of its gross domestic product (GDP), is the unavoidable legacy of past trade imbalances.

3. H. Clinton, "Hillary Clinton's Trade Agenda Making Trade Work for Indiana Workers and Families", Press Release, University of Santa Barbara, April 30, 2008, available at: www.presidency.edu.
4. P. Krugman, "What's Driving Dollar Doomsaying?", *New York Times*, March 7, 2023, available at: www.nytimes.com; B. S. Bernanke, "The Dollar's International Role: An 'Exorbitant Privilege?'" Brookings Institution, January 7, 2016.

As a result, the United States and China are financially "condemned to compete and to cooperate."[5]

This paper will not offer a definitive answer to the question of who holds the leverage in a financially unbalanced relationship; indeed, a definitive answer probably cannot be provided in the absence of a crisis. It will, however, try to inform the discussion through a review of the debate over the financially unbalanced Sino-American relationship during the past twenty-plus years and the shifts in perceptions of how financial interdependence can be weaponized.

It starts with the US debate over concerns that relying on China's government to fund the US trade deficit created a strategic vulnerability between 2004 and 2008. It then reviews the Chinese debate over the risks perceived from its large stock of financial claims on the US – the counterparty to an unbalanced trade relationship – after the global financial crisis. Also considered are China's efforts to develop the Belt and Road Initiative to limit its financial exposure to the US while maintaining the underlying trade imbalances. Finally, it examines how sanctions have been used to weaponize financial interdependence and the potential for sanctions to transform large holdings of bonds and other financial assets into a financial vulnerability.

5. "External Sector Report 2023: External Rebalancing in Turbulent Times", International Monetary Fund, 2023, available at: www.imf.org; G. Allison, "Can Two Great Powers Cooperate to Build a Safer World? It Has Happened Before", *Washington Post*, June 14, 2023, available at: www.washingtonpost.com.

The balance of financial terror

Former US Treasury Secretary Larry Summers arguably kicked off the debate over the strategic consequences of the US unbalanced trade and financial relationship with China. While recognizing the economic realities that limited the risk of a Treasury sell-off, Summers' warning about the danger of having financial stability depending on the policy choices of a strategic rival was prescient and came to be broadly shared in the US.

Summers' observations

Prior to the US presidential election of 2004, Summers argued that global financial stability hinged on a new "balance of financial terror"[6]:

> "There is surely something odd about the world's greatest power being the world's greatest debtor. In order to finance prevailing levels of consumption and investment, must the United States be as dependent as it is on the discretionary acts of what are inevitably political entities in other countries? It is true and can be argued forcefully that the incentive for Japan or China to dump treasury bills at a rapid rate is not very strong, given the consequences that it would have for their own economies. That is a powerful argument, and it is a reason a prudent person would avoid immediate concern. But it surely cannot be prudent for us as a country to rely on a kind of balance of financial terror to hold back reserve sales that would threaten our stability."

The background to Summers's comment was simple: the US trade and current account deficits were rising and, unlike in the late 1990s, the US external deficit was not financed primarily by private financial inflows. An enormous acceleration in the growth of reserves in surplus countries – Japan in 2003 and 2004, followed by China and other Asian emerging economies – led to equally enormous demand from reserve managers for US bonds. Those countries bought these bonds because they didn't want their currency to rise against the dollar (or, for that matter, against the currencies of trade rivals who were pegged to the dollar). However, the result was that the net financial flow that sustained a large US external deficit stemmed from the policy choices of a small number of governments, not the activities of autonomous market actors. Summers drove this point home later that year[7]:

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6. L. Summers, "The United States and the Global Adjustment Process", Institute for International Economics, March 23, 2004.
7. L. Summers, "The U.S. Current Account Deficit and the Global Economy", Lecture presented at the Per Jacobsson Foundation, Washington, D.C., October 3, 2004. In Proceedings of the 2004 Annual Meetings

> "I have previously used the term "balance of financial terror" to refer to a situation where we rely on the costs to others of not financing our current account deficit as assurance that financing will continue. The term may overdramatize the problem, but this is surely a situation of concern."

Summers' analogy was arguably imprecise – in the Cold War, both Russia and the US possessed nuclear weapons: the balance of nuclear terror reflected the consequences of an arms race where both parties acquired similar military capabilities. The post-Cold War financial order that emerged after the Asian financial crisis and the collapse of the dot-com bubble was marked by clear asymmetries: China's government owned far more US bonds than the American government owned Chinese bonds, and China's economy relied far more on US demand than the US economy relied on Chinese demand.

This asymmetry meant that the US government could not respond to a Chinese policy decision to sell US bonds in a disruptive manner with an offsetting sale of Chinese bonds – or, at least at the time, with sanctions that forced private US investors to sell Chinese bonds. However, any Chinese action that put the US economy at risk would lead to a fall in US demand for goods that would put China's own unbalanced economy at risk, hence the postulated fragile incentive for stability.[8]

The buildup continues

Summers's argument was, in a sense, early. In 2004, China only had $600 billion in foreign exchange reserves.[9] The state banks had the $45 billion in foreign assets they obtained from China's 2003 recapitalization, but little more. That was substantial relative to China's GDP of around $1.7 trillion, but China's $235 billion in US Treasury holdings (and $135 billion in holdings of US Agency securities) were not especially large relative to the US economy at the end of 2004.

However, China's accumulation of US assets accelerated after Summers' warning. By mid-2008, China had well over $1.8 trillion in reserves – with $520 billion in Treasuries and $527 billion in long-term Agency securities.

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of the Boards of Governors of the International Monetary Fund and the World Bank, edited by Archana Kumar, Washington, D.C.: IMF Multimedia Services Division, 2004, p. 8; S. S. Cohen and J. Bradford DeLong, *Concrete Economics: The Hamilton Approach to Growth and Policy*, Cambridge: Harvard Business School Review Press, 2016; J. Fallows, "The $1.4 Trillion Question," *The Atlantic*, February 15, 2008, available at: www.theatlantic.com.

8. T. Gomart and S. Jean, "Impossible Decoupling, Improbable Cooperation: Economic Interdependencies in the Face of Power Rivalries", *Ifri Studies*, November 2023.

9. "Foreign Currency Reserves, 2004", People's Bank of China, In Haver Analytics.

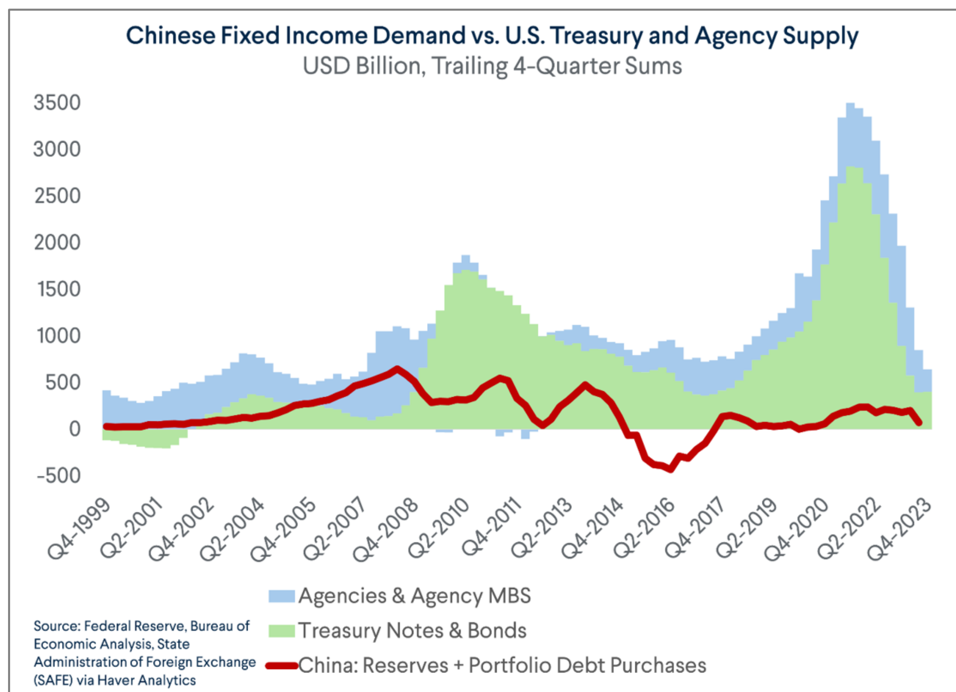
Figure 1. Chinese Reserves Growth vs. Treasury Long-Term Issuance

That total would have been higher, but for the $100 billion moved to the state banks in 2006 through cross-currency swaps, the $60 billion plus moved to the state banks in a series of recapitalizations, and the well over $200 billion in foreign exchange that China mandated its state banks to hold in required reserves in 2007 and 2008. Counting these not-so-hidden reserves, China's reserves topped $2 trillion – at a time when China's GDP was only $4 trillion.[10]

China's demand for US financial assets was equally insatiable. We now know that China started to reduce the dollar share of its ever-increasing reserves after 2005 (according to data released in SAFE's annual reports, China's dollar share fell from 79% in 2005 to around 59% in 2015). China added roughly $250 billion (in dollars) to its reserves in 2005, almost $300 billion in 2006, and over $450 billion in 2007 and 2008, so China's State Administration of Foreign Exchange (SAFE) needed to increase its holdings of dollar reserves by roughly $1 trillion over four years.[11]

10. R. McGregor, "China Ponders its Foreign Exchange Riches", *Financial Times*, September 24, 2006, available at: www.ft.com.
11. "Annual Balance of Payments Statistics", International Monetary Fund, In Haver Analytics. Accessed April 8, 2024.

Figure 2. Chinese Fixed Income Demand vs. U.S. Treasury and Agency Supply

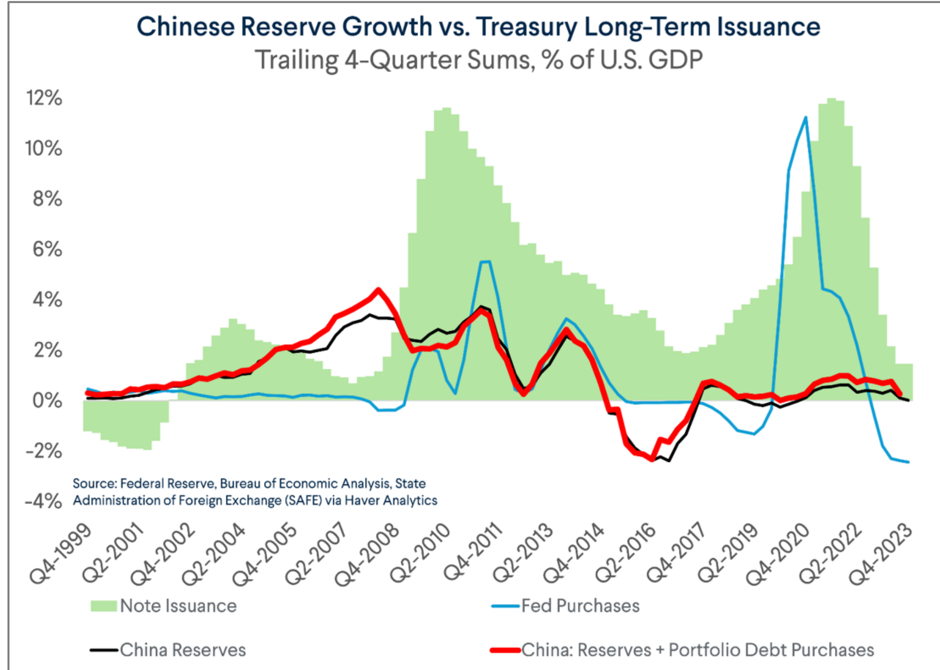


The pace of China's reserve growth was large relative to the US Treasury's net issuance of notes in those years ($216 billion, $203 billion, and $134 billion in FYs 2005, 2006, and 2007 respectively).[12] This under-examined financial detail helps to explain why reserve flows were channeled through global intermediaries into the US housing market.[13]

12. "Quarterly Refunding Charts", US Treasury, October 30, 2006, available at:, https://home.treasury.gov; US Treasury, "Quarterly Refunding Charts", October 29, 2007, available at: https://home.treasury.gov.

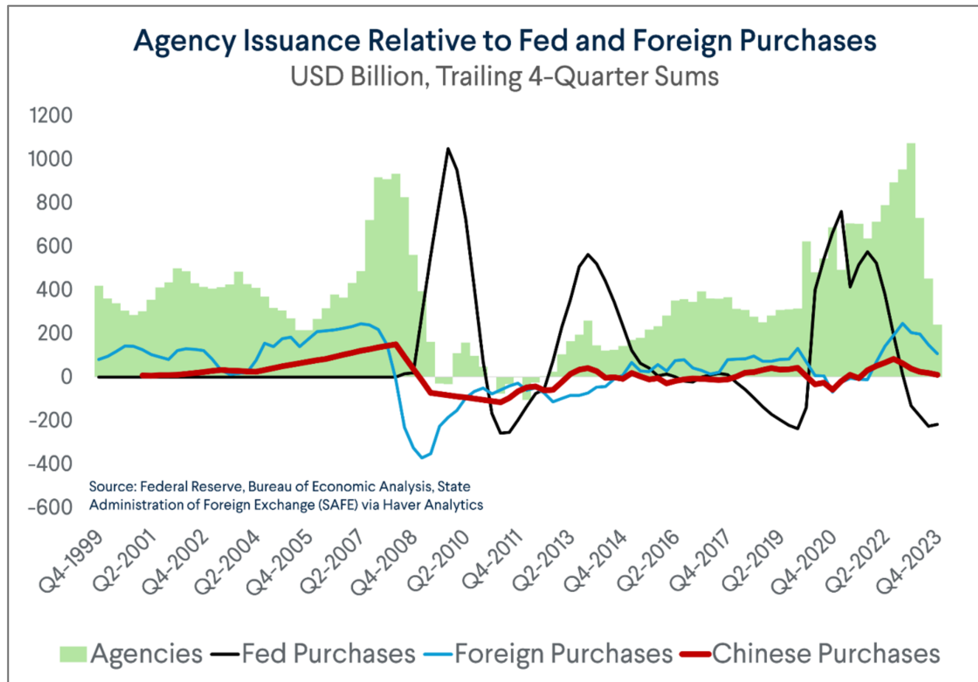
13. A. Brender and F. Pisani, "Global Imbalances and the Collapse of Globalised Finance", Brussels: Centre for European Policy Studies, 2010; B. Setser, "Capital Flows into the United States Ahead of the Great North American Financial Crisis", presented at "The 2008 Global Financial Crisis in Retrospect," Reykjavik, August 30-31, 2018, New York: Center for Financial Stability, 2018.

Figure 3. Chinese Reserve Growth vs. Treasury Long-Term Issuance



China solved the narrow financial question of where besides Treasuries to place its reserves by holding an ever-growing portfolio of government-sponsored enterprise (GSE) securities, also referred to as Agency bonds or Agencies. In fact, in mid-2008, just prior to the global financial crisis, China held slightly more Agency bonds than Treasuries and maintained Agency holdings in mid-2008, which topped 10% of its GDP.

Figure 4. Agency Issuance Relative to Fed and Foreign Purchases



This flow into Agencies wasn't widely followed or well understood at the time; public debate tended to focus exclusively on China's Treasury holdings. But the most important test of stability in the "balance of financial terror" emerged from the market for Agency bonds, not the market for Treasuries.

The agony of Hank Paulson

Hank Paulson forged his career at Goldman Sachs, in no small part, out of the Sino-American financial relationship. In the years between the Asian financial crisis and the global (or North Atlantic) financial crisis, China's government – led by the People's Bank of China (PBOC) – sought out foreign investors to participate in the capital structure of the newly recapitalized big state commercial banks. Hank Paulson personally advised the Chinese throughout this period, and in 2006, Goldman Sachs invested $2.6 billion in Industrial and Commercial Bank of China (ICBC) for a 5.75% share. At the time, this was the single largest investment in the firm's history.[14]

A strained relationship

When Paulson accepted the job of US Treasury Secretary in George W. Bush's second term, he hoped to institutionalize the Sino-American financial relationship he had facilitated while at the helm of America's leading investment bank. In the summer of 2008, however, that financial relationship was under significant strain. The US housing downturn created severe pressure on the balance sheet of the two large GSEs (the "Agencies") that backstopped a significant part of the US mortgage market: the Federal Home Loan Mortgage Corporation ("Freddie Mac") and the Federal National Mortgage Association ("Fannie Mae").

Paulson – and much of Wall Street – believed that stability in the market for Agency debt, while the US worked to engineer a backstop for the Agencies' capital, depended in part on continued Chinese purchases of Agency bonds. China was, it seemed, surprised to discover that the safety of its US investments was a function of the willingness (and ability) of the US government to backstop the GSEs and ensure that they had enough capital to absorb housing-related losses.

Even as the US feared China would sell its US bonds, jeopardizing US financial stability, China feared that the health of its central bank balance sheet would be jeopardized if the US did not provide a backstop to the GSEs. That turned out to be the true balance of financial terror. Paulson observed[15]:

14. K. Linbaugh, "Goldman to Reap Handsome Profit on Chinese IPO," *Wall Street Journal*, September 28, 2006, available at: www.wsj.com.

15. H. M. Paulson, *Dealing with China: An Insider Unmasks the New Economic Superpower*, New York: Twelve Books, 2015, p. 256.

> "If China had suffered losses on its vast holdings of Fannie or Freddie securities, there could have been a huge political problem and loss of confidence in the government."

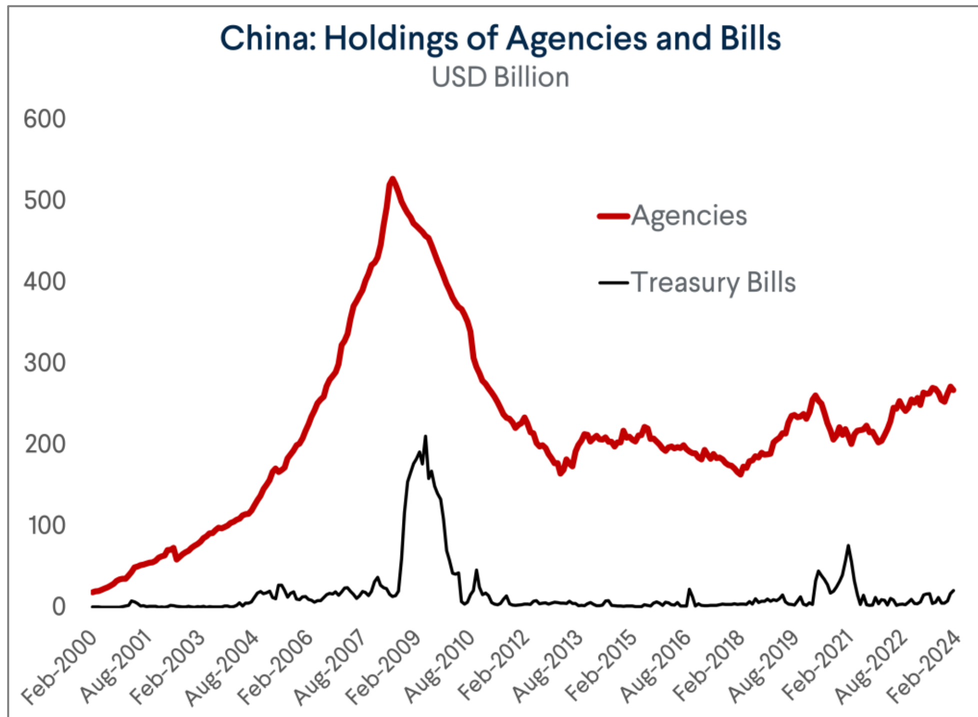
Top Treasury officials, including Under Secretary for International Affairs David McCormick, were constantly on the phone with China's SAFE, offering reassurance in the summer of 2008. Those fears only increased when Paulson got word at the Beijing Olympics that Russia was dumping its (then substantial) holdings of short-term Agency securities[16]:

> "While in Beijing, I received some disturbing news: I was told that Russian officials had made a top-level approach to the Chinese with the suggestion that together they might sell some of their GSE securities to force the U.S. to use its emergency authorities to support the companies. I didn't know how serious the Russians were about their proposal, which could have hurt GSEs and the capital markets [...] The Chinese had declined to go along with the plan and would show admirable resolve in cooperating with our government and in maintaining their holdings of U.S. securities throughout the crisis."

Paulson had indicated that China promised not to sell its existing holdings and credits China for not making the Agency's financial position worse. The actual data is more ambiguous. Chinese (essentially SAFE) holdings of Agency bonds peaked at $527 billion in June 2008 and appear to have fallen a bit between the summer of 2008 and the end of 2008, when they dipped to $490 billion even as China's reserves continued to increase. This reduction could be explained largely by the passive roll-off of existing Agency holdings; it need not imply sales. But there is no doubt that China substantially reduced its Agency holdings after Paulson stepped down, with holdings of these securities falling rapidly in 2009 and 2010 before stabilizing at around $200 billion.

16. Ibid., pp. 249-250.

Figure 5. China: Holdings of Agencies and Bills



Ultimately, the US did recapitalize the GSEs. Moreover, the Federal Reserve entered the market to buy Agency bonds in 2009 and 2010, which helped SAFE and other large foreign investors in the Agency bond market reduce their exposure. The US – through the actions of the Federal Reserve as well as the Treasury –thus both provided China with liquidity (the ability to sell their bonds without moving the market against them) and delivered on Paulson's private commitment that China's state investor would not take losses after personally reviewing the Agency bailout[17]:

> "Later that day, I got on the phone to walk Zhou Xiaochuan and Wang Qi-Shan through our decision [to provide a capital backstop of up to $100 billion for both Freddie and Fannie]. From the start of the crisis, we had decided to be frank about any problems, and they had trusted us and helped to steady markets at a fraught time […] 'Your investments are in good hands'."

Like most big market players, China had multiple layers of exposure to troubled US financial institutions. In an episode that is now largely forgotten in Washington but likely still remembered in parts of China, China's new sovereign wealth fund, the China Investment Corporation (CIC), had put $5 billion of its initial infusion of dollars into "Reserve Primary" – a money market fund. It turned out that Reserve Primary was significantly invested in Lehman Brothers short-term debt securities, providing enough financing

17. Ibid., pp. 251-252.

that the value of this “safe money market” fund fell below par (it “broke the buck”) after Lehman’s default.

These losses prompted other Chinese institutions to reduce their exposure to US banks before the PBOC – with Paulson’s encouragement –, intervened[18]:

> “[Treasury Under Secretary] Dave McCormick rushed into my office to declare: ‘I’ve got really bad news. The Chinese are moving their money.’ [… after Reserve Primary] Dave had begun hearing from Wall Street that nervous Chinese banks had been withdrawing large sums from the money market. We’d heard, too, that the Chinese were pulling back on secured overnight lending, afraid of counterparty risk. And they had begun shortening the maturity of their GSE holdings. We didn’t know quite what to make of this, though the implications were ominous […] I asked Dave to find out what was going on.”

Governor Zhou subsequently reported that Chinese institutions had indeed been pulling back but assured the US Treasury that it wasn’t being done in a coordinated manner – and told the US that the Chinese were “… going to give some guidance, particularly about the overnight lending and the pullback from the Reserve fund,” even after the US had guaranteed money market funds. Shortly afterward, nervous Chinese institutions reversed course.[19]

Financial diplomacy to the rescue?

Unsurprisingly, Paulson concluded that China had been on net a stabilizing market force over the course of 2008, thanks in part to US Treasury diplomacy:[20]

> “True I can’t draw a straight line from the personal trust and frequent informal communications fostered through the [Strategic Economic Dialogue] discussions to China’s restraint during the financial crisis, but there is no doubt in my mind there was a connection. This achievement may have fallen outside the list of deliverables, but its importance during a dire period for the United States is impossible to overstate.”

More broadly, the GSE bailout, together with the money market bailout, thus seems like a clear case in which China exercised leverage as a creditor. The US government took a set of actions that had the effect of protecting the value of China’s core investments in the US and communicated to Chinese policymakers that the US understood its financial interest out of a clear conviction that China’s actions could impact US market outcomes. Wang Qi

18. Ibid., p. 254.
19. Ibid., p. 254.
20. Ibid., p. 256.

Shan told Paulson: “We are watching this very carefully. We want to make sure you are going to protect our financial interests.”[21]

The reality, however, is more complex. The federal bailout of the GSEs was overdetermined. China was an important creditor, with around 7 % of its outstanding debt. Yet far more was held within the US financial system. Moreover, the GSEs were central to the provision of mortgages in the US, particularly after the collapse of the “private label” asset-backed securitization business during the crisis. Realistically, the GSEs were likely to be recapitalized regardless of who held their bonds. These institutions are simply too big – and too important to the US financial system – to fail.

Similarly, the US government's backstop for the money market fund industry was not driven primarily by the need to protect the flow of Chinese funds into the US Domestic investors were far more important sources of funding for the money markets, and the collapse of money market funds would have had a devasting impact on many US and European financial institutions who relied on them for short-term financing.[22]

Yet there is no question that concerns of China selling loomed large in the mind of Treasury Secretary Paulson throughout the summer and fall of 2008. Paulson’s background made him particularly sensitive to Chinese concerns and arguably elevated China’s influence beyond what it would otherwise have been.

Setting aside those historical contingencies, this is the best example of a case in which the Chinese threat – or perceived threat – of sales did have an impact on American policy. Hank Paulson has said as much on multiple occasions[23]:

> “Our ability to communicate and coordinate with top Chinese leaders 24/7 during the height of the panic was important to helping us avoid another Great Depression because China was a huge holder of corporate, banking and Fannie Mae and Freddie Mac securities.”

But the lessons for the US were perhaps more important. Extensive diplomacy didn’t avoid all Chinese sales – China no doubt appreciated the steady drum of calls from Treasury Undersecretary David McCormick, but it still decided to reduce its Agency exposure even if it initially avoided direct sales. The ultimate backstop to the Agency bond market was not China’s willingness to buy in a crisis, but some combination of the fiscal capacity of the US Treasury and the ability of the Federal Reserve to buy Agency bonds.

21. B. Davis and L. Wei, *Superpower Showdown: How the Battle Between Trump and Xi Threatens a New Cold War*, New York: Harper Business, p. 129.
22. T. F. Geithner, *Stress Test: Reflections on Financial Crises*, New York: Crown Publishing Group, 2015.
23. B. Davis and L. Wei, *Superpower Showdown*, op. cit., p. 130.

Quantitative easing is now associated largely with Treasury purchases, but "QE1" was far more focused on Agency bond purchases.[24]

The imbalance unmasked

What conclusions should be drawn from the era defined by an ever-increasing Chinese financing of the US, or what might be called a steady escalation in the balance of financial terror?

Firstly, it didn't end well for the US, but not for the reasons initially feared; it didn't end because China stopped buying US bonds. Rather, it ended because Chinese demand for safe US assets (linked to its own undervalued currency) created a scarcity of safe assets which incentivized financial actors in the US and Europe to reach for yield via the US mortgage market. "Chains of financial intermediation broke down" before the era of financial terror ended. There were limits on the ability of actors other than the US government to create safe assets. Large external deficits were not, in fact, a sign of strength.[25]

The US also learned that it could accommodate a reduction in Chinese demand for the second most important category of US bonds. The Federal Reserve had to adopt a set of policies that resulted in a more elastic balance sheet (QE1) to avoid a widening of Agency bond spreads and a broad collapse in the mortgage market. But Agency bonds eventually rallied, and GSE-backed mortgages retained their central place in the US financial system even though foreign central banks didn't return to the market.

Of course, foreign participation in the Treasury market is much larger, but the same broad conclusion holds: for bonds that it can buy, the Federal Reserve can assure that long-term US rates are determined primarily by expectations about the path of short-term US rates, not by expectations about the scale of foreign demand. The impact of the Fed buying on the market is now taken for granted, but it is something that many observers – myself included – largely missed prior to the fall of 2008. Subsequent rounds of asset purchases, including the Federal Reserve's actions during the global pandemic, have demonstrated that the Federal Reserve purchases of Treasuries can far exceed China's potential sales.

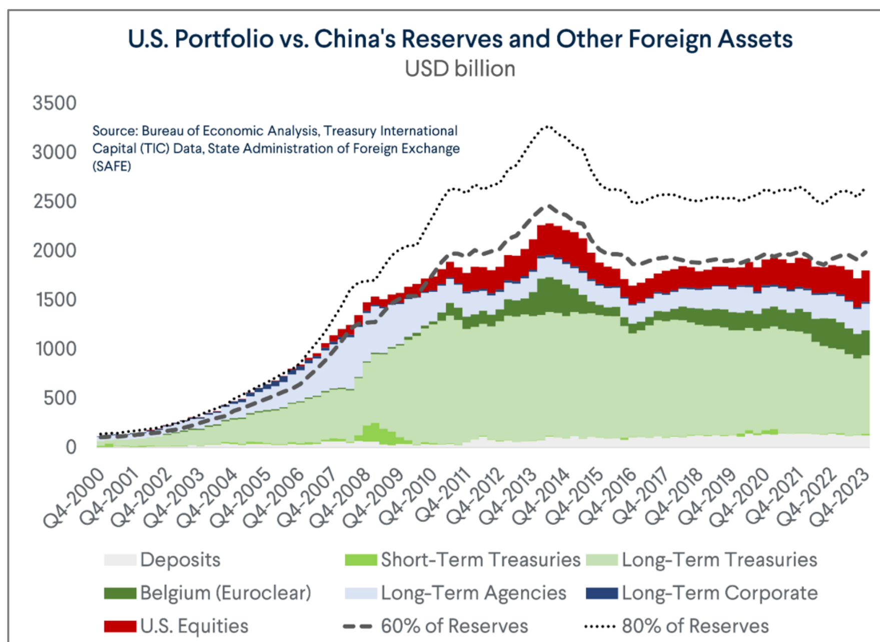
Moreover, the full global impact of a coordinated shift out of US Treasuries and the dollar in an effort to pressure the US – whether over economic or foreign policy choices – wasn't really tested. The "stress test" came from a shift out of Agency bonds and bank deposits into Treasuries. The dollar famously rallied in the crisis, though this was more the result of an unwind in dollar-funded carry trades than an increase in demand for US assets

24. A. Krishnamurthy and A. Vissing-Jorgensen, "The Effects of Quantitative Easing on Interest Rates: Channels and Implications for Policy", Washington, DC: Brookings Institution, 2011.
25. B. Setser, "Capital Flows into the United States Ahead of the Great North American Financial Crisis", op. cit.

– foreign claims on the US actually fell, but so did US bank claims on the world.[26] In fact, after US demand collapsed and the Federal Reserve cut dollar rates to zero, many exporting economies became even less willing to accept an appreciation of their currency against the dollar and increased their intervention, leading to a rapid recovery in central bank demand for US bonds.

Lastly, China seems to have concluded that any strategic leverage it gained through its large holdings of US bonds was offset by the political costs inside China associated with putting so much of its citizens' savings in US financial assets. Chinese policymakers noted that the value of their Agency holdings was ultimately determined by US actions, and thus that Agency bonds were not as safe as "SAFE" believed.

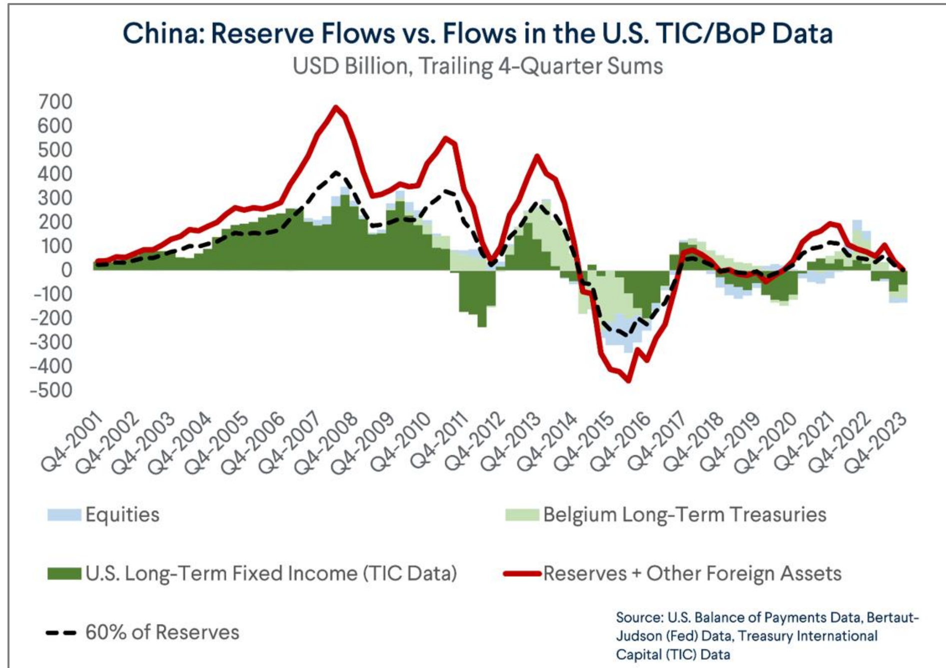
Figure 6. U.S. Portfolio vs. China's Reserves and Other Foreign Assets



After shifting its portfolio into Treasuries during the global financial crisis, China complained that the US fiscal policy was flooding the global market with too many bonds while the Federal Reserve was adding too many dollars to the global monetary supply, reducing the value of China's holdings.[27]

26. B. Setser, "Three Sudden Stops and a Surge", *Follow the Money*, Council on Foreign Relations, September 20, 2018, available at: www.cfr.org.
27. G. Dyer, "Wen 'Worried' About China's US Assets", *Financial Times*, March 13, 2009, available at: www.ft.com; A. Batson and A. Browne, "Wen Voices Concern Over China's U.S. Treasurys", *Wall Street Journal*, March 13, 2009, available at: www.wsj.com; Z. Z. Liu, *Sovereign Funds*, Cambridge: Harvard University Press, 2023, pp. 58-59. Liu Writes: "The competing proposals all reflected a concern that China had an overly concentrated investment position in US Treasuries. Chinese economists perceived this

Figure 7. China: Reserve Flows vs. Flows in the U.S. TIC/BoP Data



exposure as risky for two primary reasons. The first reason was the risk of investment loss due to the falling value of the US dollar. Between 2002 and 2006, the US dollar depreciated by about 25% against a basket of other major currencies. The second reason was the ultra-low yield on US Treasuries, which imposed an opportunity cost on China. Since the 1980s the yield on US Treasuries relative to nearly all other asset classes had been in near-perpetual decline."

The Belt and Road: China's alternative to treasuries

Today, China holds a relatively low share of the foreign assets of China's state in Treasury bonds. By 2022, China's total foreign assets – counting the assets of the state commercial banks, the state policy banks, and the CIC, as well as the reserve assets of SAFE – were around $6 trillion. China's reported holdings of Treasuries, plus the Treasuries held in Euroclear (a Belgian custodian), are around $1 trillion.[28]

The low share of Treasuries in the broad portfolio of China's state is not an accident. As the work of Zoe Liu demonstrates, Chinese policymakers had started to worry that the large Chinese reserve holdings of US bonds were a domestic political vulnerability even before the global financial crisis. Chinese leaders worried about the domestic perception that China had financed unsound US policies.[29] Between 2006 and 2010, China concluded that it had better things to do with its foreign portfolio than simply fund the US Treasury and get criticized by both the Treasury (for buying dollars in the foreign exchange market) and Chinese nationalists (for providing so much funding for the government of China's strategic rival).

China diversifies

Both the creation of CIC and, more significantly, the decision to "diversify" SAFE's reserves by providing funding for China's policy banks so that they would support the Belt and Road Initiative were motivated by a desire by China's policymakers to find alternatives to the Treasury market.[30]

Zoe Liu's study of Chinese sovereign investment funds documents how this was a very conscious decision, reached after much internal deliberation and debate[31]:

> "In March 2011 the reserves topped $3 trillion for the first time, by far the most held by a central bank in modern history. Domestic calls to use the reserves to support economic and social development grew louder. The most convincing argument was that the best way to reduce the opportunity costs of holding excess reserves in US Treasuries would be to invest instead in overseas strategic assets. China's top policymakers publicly

28. B. Setser, "How to Hide Your Foreign Exchange Reserves—A User's Guide", *Follow the Money*, Council on Foreign Relations, June 29, 2023, available at: www.cfr.org.

29. Z. Z. Liu, *Sovereign Funds*, op. cit., pp. 61-62.

30. B. Setser, "How to Hide Your Foreign Exchange Reserves—A User's Guide", op. cit.

31. Z. Z. Liu, *Sovereign Funds*, op. cit., p. 153.

> expressed concerns over China's excess reserves and the rising opportunity costs of traditional management strategies. China's central bankers, such as Governor Zhou, no longer stood by the conventional wisdom that buying US Treasuries was the best way to invest reserves. Governor Zhou publicly acknowledged that China's reserves had already surpassed their optimal level, that reserves diversification was imperative, and that CIC was an apt example to follow."

Put differently, China concluded that it could minimize the domestic political risk created by the appearance of funding US policies and increase its geopolitical leverage by channeling its funds through its policy banks and sovereign funds to many lower-income and emerging markets. The desire to obtain strategic assets had helped motivate the creation of the CIC before the global financial crisis. As Liu writes[32]:

> "[...] the launch of CIC was [...] another reflection of the Party-State's desire to take risks and use China's financial power to shape global markets. The goal is to transform China's foreign exchange reserves into strategic overseas assets and seek higher financial and political returns on investments."

The post-crisis decision to transform the policy banks into competitors with the multilateral development banks – including the World Bank – had a similar motivation. Liu quotes SAFE official Li Hongyan, who argued that "creating policy banks and sovereign funds provides a sustainable mechanism to put China's foreign exchange reserves to work in service of China's national strategies."[33]

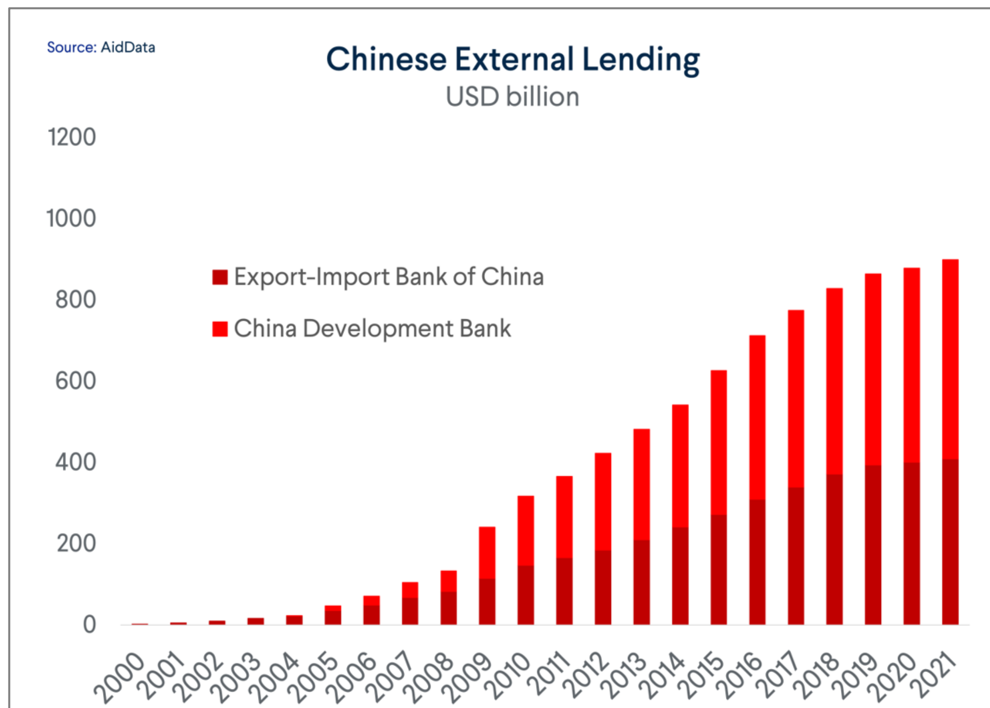
This shift was predictable.[34] The precise political impact of China's vast policy lending and strategic investments from various state investment funds can be debated, but its scale is genuinely impressive:

- The CIC has a foreign portfolio of well over $300 billion.
- The Export-Import Bank of China (Exim) has lent out $500 billion – more than the World Bank has lent out over its seventy-year history.[35]
- The China Development Bank's (CDB's) lending, while a bit different in structure (it tends to be at higher rates), is comparable in scale. So, from 2010 to 2020, Chinese state lenders lent out roughly as much, on net, in ten years as all the world's multilateral development banks did over seventy years.[36]

32. Ibid., p. 91.
33. Ibid., p. 68.
34. B. Setser, "Sovereign Wealth and Sovereign Power: The Strategic Consequences of American Indebtedness", New York: Council on Foreign Relations, 2008.
35. O. Moses, I. Ratan, and L. Engel, "FAQs: Data Analysis on Chinese Overseas Lending and Development Finance", Boston University Global Development Policy Center, 2023, available at: www.bu.edu.
36. "Global Chinese Development Finance Dataset, Version 3.0", AidData, November 6, 2023, available at: www.aiddata.org.

- The latest reporting from AidData suggests a total lending of $900 billion by CDB and Exim, a sum comparable to China's Treasury lending.[37]
- The Silk Road Fund, the China-Africa Development Fund, and the China-Latin America and Caribbean Fund (LAC) Cooperation Fund were all launched in the last 20 years.

Figure 8. Chinese External Lending



It thus would be a mistake to view China's attempt to transform the vast financial resources acquired through its sustained external surplus into political and strategic leverage purely in terms of its efforts to influence US policy. China's financial strategy over time has moved away from buying classic US reserve assets toward using its surplus foreign exchange to help construct a network of ties that cemented its place as a global rival to the US. Those financial ties, at least initially, created strong incentives for countries receiving Chinese financing to provide China with the "respect" it craves and to avoid directly challenging core Chinese interests.[38]

37. "China as an International Lender of Last Resort Dataset, Version 1.0.1", AidData, March 27, 2023, available at: www.aiddata.org.
38. D. Brautigam, *The Dragon's Gift: The Real Story of China in Africa,* Oxford: Oxford University Press, 2011.

The downside of lending *en masse*

It is always easy for a banker to make friends when the bank is lending freely. The challenge China currently faces isn't lending but rather getting repaid.

While some countries, such as Laos, that borrowed almost exclusively from China, have been able to address debt problems through bilateral negotiations directly with Chinese creditors, most other countries borrowed from multiple creditors and have consequently had to seek debt relief from multiple creditors, not just China. This generally has required working through the traditional structures for managing cross-border financial distress centered around the International Monetary Fund (IMF).

As a result, China's influence in both Zambia and Sri Lanka waned after each of these countries defaulted on Chinese loans. Previously hidden debts have had to be transparently reported, and China has had to negotiate the restructuring of its claims either together with other creditors (as in the case of Zambia) or in tandem with other creditors (Sri Lanka). The overall parameters for the restructuring have been set not by Chinese policy lenders, but by the IMF.

Flipping the vulnerability: Sanctions as a source of leverage

The United States' vulnerability – as a country that relied on external inflows to cover an ongoing external deficit at a reasonable interest rate and, in the process, often saw significant foreign inflows into its bond market – was to a cutoff in new financial flows.

Creditors, by contrast, rely on a debtor country to preserve the value of their investments – and ultimately to allow creditors the option of getting their money back. Of course, one creditor is usually paid out of inflows from another creditor, not sustained surpluses. But the essential point is that creditors put their principal at risk when they extend credit, and a steady inflow of credit leaves the creditor with a large stock of claims on the borrowing country.

The US has long used the dollar's centrality to a range of international transactions as a source of leverage. Limits on a country's use of the dollar cut it off from the main network used for international payments, and, by threatening banks that use another currency to conduct transactions with a sanctioned entity with the loss of access to dollar payments, the reach of sanctions has extended further.

US sanctioning power also includes the ability to immobilize (or freeze) dollar assets held by a sanctioned entity, turning foreign holdings of dollars into a potential source of leverage. As Daniel McDowell summarizes[39]:

> "To adopt a famous phrase coined by US Secretary of State Madeline Albright, the dollar is the indispensable currency of global finance and commerce. If Washington wishes to prevent a foreign entity from accessing its dollar-denominated assets or block it from completing a cross-border transaction using dollars, it can do so with little more than the stroke of a Presidential pen."

The development of sanctions as a financial weapon

The structure of modern US sanctions was forged first in the effort to convince Iran to give up its nuclear program, and even more by the effort to punish Russia for its invasion of Crimea in 2014 and subsequent full-scale invasion of

39. D. McDowell, *Bucking the Buck*, Oxford: Oxford University Press, 2023, p. 19.

Ukraine in 2022. This included efforts to cut off state banks and state firms from access to new dollar finance (and, given the full participation of the G7 in these sanctions, access to euro finance) in 2014, and the immobilization of Russia's dollar and euro reserves and other offshore assets of the Russian state. Given China's structural current account surplus, vast reserve assets, size, and global importance, the Russian example is of particular importance for any discussion of China's own vulnerability to sanctions.

Just as Russian policymakers sought to reduce their vulnerability to unilateral US sanctions by diversifying their reserves away from the dollar (and moving out of US custodians) after the US demonstrated its willingness to freeze Libyan and Iranian central bank reserves, Chinese policymakers have to be aware of the possibility that their reserve assets – and the foreign operations of the large Chinese state banks – could become pawns in a broader geopolitical game.[40] McDowell states this stark reality clearly: "Dollar dominance gives the United States unrivaled capacity to cut foreign actors off from their dollar assets and the dollar-based international financial system".[41]

Chinese state actors are vulnerable to both denial of access to new dollar and euro financing, as well as asset freezes. The denial of new financing accounted for the bulk of the sanctions on Russian state banks and Russian state-owned oil companies after Russia's invasion of Crimea in 2014. Such sanctions force a state financial institution to draw down its existing assets to repay its debts, secure emergency financing from the central bank, sell domestic currency to buy foreign currency (thus putting pressure on the exchange rate), or simply default and hand over any external assets to its creditors.

Such sanctions were used with the expectation that Russia would choose to use its reserves to allow payment rather than default – an expectation that has been borne out. Ironically, access to a large stock of (unsanctioned) foreign assets – notably central bank reserves – is the best countermeasure to sanctions. Central bank foreign exchange financing replaces external financing; the sanctioned state bank or firm is largely protected from any adverse effect.

The Chinese view

But from China's point of view, the sanctions that denied Russian banks and, critically, the government of Russia access to their dollar and euro assets pose more significant risks. The G7 acted collectively to freeze external assets of both a significant portion of Russia's state banking system and approximately $300 billion of the Russian central bank's assets. Denial of

40. Ibid., pp. 48-49. McDowell writes: "Washington's demonstration that it was willing and able to freeze central bank reserves [in Libya and Iran] left an indelible impression on Russia policymakers. The dollar's appeal as a reserve currency quickly declined."

41. Ibid., p. 9.

access to financial assets or reserves turns a country's assets abroad into, at least in theory, a political liability – as the country whose assets have been frozen would need to negotiate to regain access to its assets. It potentially sets the stage for seizing the country's reserves and a transfer of ownership.

These different sanction regimes pose a dilemma for countries like China. The large reserve holdings that China has long viewed as a source of insulation from financial pressure from abroad create a hard-to-avoid vulnerability to a "freeze". Put simply, China's holdings of dollar bonds started to look less like a source of leverage that China might exert over the US and more like a financial hostage that the US might seize if tensions over Taiwan should escalate.

China is particularly constrained in its ability to simply reduce its external asset portfolio by the fact that there isn't another comparably large economy in its block that could absorb its 5 to 6 trillion dollars in foreign assets – China uniquely cannot hold a share of its foreign assets inside China, and thus lacks a key diversification option available to countries like Russia.[42]

Moreover, through the Belt and Road, China has already diversified a significant share of its reserves out of US credit. This has, of course, created another set of vulnerabilities, given the difficulties some countries face repaying their loans to the CDB and Exim.[43] China is, one would suspect, aware of this dilemma.

After Russia's reserves in the G7 countries were frozen, China's central bank is reported to have convened a group of bankers to discuss ways of minimizing its sanctions exposure.[44] But it isn't clear that China can do substantially more than it already has – shifting out of dollars and into euros doesn't provide protection if the G7 acts collectively, and with a current account surplus, China can only reduce its reserve holdings if it draws on its reserves to cover significant private outflows from China. After the freeze on the foreign assets of several of Russia's state banks and central bank, there has not been a noticeable shift in the external portfolio of China's state. The much-discussed reduction in China's Treasuries held in US custodians has largely been offset by an increase in its holdings of US custodied Agency bonds, and a likely rise in the Treasuries it holds in offshore custodians such as Euroclear.

It is worth noting that in the case of China, the pool of external assets subject to sanctions potentially extends well beyond the central bank's reserves. The CIC has $300 billion in foreign assets. The state commercial banks have $1.2 trillion. The Bank of International Settlements data on the

42. C. Weiss, "Geopolitics and the U.S. Dollar's Future as a Reserve Currency", Washington, DC: Board of Governors of the Federal Reserve, 2022.

43. A. Gelpern, S. Horn, S. Morris, B. Parks, and C. Trebesch, "How China Lends: A Rare Look into 100 Debt Contracts with Foreign Governments", Williamsburg: AidData, 2021.

44. S. Yu, "China Meets Banks to Discuss Protecting Assets from U.S. Sanctions", *Financial Times*, April 30, 2022, available at: www.ft.com.

claims of Chinese banks on external counterparties – a dataset that includes the two main policy banks as well as the commercial banks – shows $2.5 trillion in external assets.[45]

The main counter available to China does not protect its existing assets but rather renders its stocks of external assets less central to its ability to conduct international transactions. Shifting external payments out of dollars and euros into renminbi would allow the settlement of payment for trade without touching dollars or euros and without requiring any use of existing external assets to settle payments.

China has undoubtedly been pursuing this option, though its success, besides payments with Russia, has been limited by the reluctance of many counterparties to accept payments in yuan (given the difficulty of using the yuan outside of China), as well as the fact that yuan holdings could themselves be weaponized.

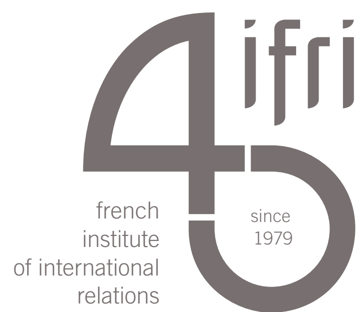
45. Bank for International Settlements, "Locational Banking Statistics", 2024, available at: https://data.bis.org.

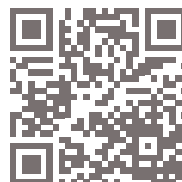
Conclusion

Sustained trade imbalances have created multiple forms of asymmetric financial interdependence, and those asymmetries create potential leverage for both parties. The US would be forced to adjust in the case of a loss of new inflows from China, while China is exposed to large losses on its significant existing stock of claims. Exercising that leverage, however, has proven difficult, as any strong financial threat carries with it the risk of significant collateral damage – and the Federal Reserve exercises more influence over the Treasury and Agency markets than China's State Administration of Foreign Exchange.

China's claims on the US remain large, but they aren't as big as they once were. China isn't a big net buyer of Treasuries these days – only a large legacy holder. Furthermore, China's claims are less significant as a share of China's own economy than they once were. In the middle of 2008, China's visible holdings of US financial assets were 30% of its GDP. By the end of 2023, that number was under 10% of China's GDP. Not all of China's exposure to US financial markets – then or now – is visible, but the broad trend has been clear. China did diversify and holds more modest reserves relative to the size of its economy than it once did.

Yet is also important to note that in a crisis, countries don't need access to external finance so much as access to real goods and services. China's leverage in an economically interdependent relationship may stem less from the large stock of financial assets under the control of China's state and more from the difficulties of finding alternatives to Chinese parts and final assembly. China's importance to the global supply of advanced manufactures has increased enormously over time. In a crisis over Taiwan, China would likely lose access to its reserves – and the G7 countries would see their supply of new cell phones disappear. It is vital to understand potential financial vulnerabilities, but also not to forget about other sources of leverage in a world where the threat of weaponized interdependence is real.





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