

ECONOMICS: SPECIAL COMMENTARY—AUGUST 27, 2010

What US Treasury Data Tell Us About China

■ **Lars Pedersen**
 Senior Economist—Global Economic Research

We view the US Treasury’s International Capital Reporting System as a valuable source of insights into how China manages money—and how these decisions affect global capital flows. One key finding: some of China’s investment shifts may have intensified global market volatility in recent years.

Up until the early 2000s, the US Treasury International Capital Reporting System captured 70%–80% of China’s reported reserves, most of which were held in US Treasury bonds. That percentage is likely to decline to about 50%, as China continues to diversify its holdings into other markets and as recent shifts into indirect holdings have yet to be reflected in these reports. Still, a careful analysis of US Treasury information offers important information on Chinese asset managers’ investment choices and their often dramatic effect on global markets.

For example, consider China’s move into US agency bonds in 2007–2008. This investment idea was likely sold to China’s asset managers as a relatively low-risk way to boost returns. However, as the financial crisis began gathering momentum in mid-2008, those managers suddenly began reducing their agency holdings. Those moves contributed to the growing problems at Fannie Mae and Freddie Mac, hastened their eventual government takeover, and may have accelerated the

events leading to Lehman Brothers’ subsequent failure.

Lehman’s collapse set off a global flight to safety. China’s reserve managers sought safety, too, but they made a larger impact because they were moving far larger sums of money than most participants. Reported US Treasury bills held by Chinese residents (which are almost exclusively official government agencies) jumped by US\$150 billion in two months (**Display 1**). What did these investors sell in such size to accumulate so much cash so fast? It’s no wonder that Lehman’s demise caused an instant shortage of US dollar balances in the euro-dollar market at the time.

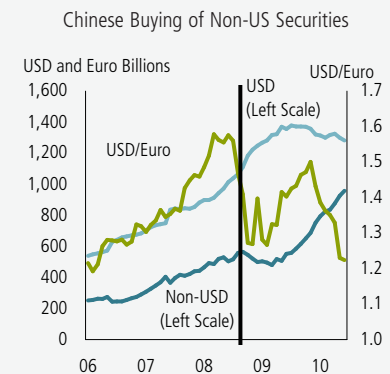
Once things settled down in early 2009, China’s reserve managers were an important part of the “wave of money” coming back into securities markets. Throughout that year, these managers reduced their cash balances, helping to fuel a reserve buildup of about US\$30 billion a month, all of which went into a massive buying program, helping to power

Display 1
Adding to the Wall of Money



As of June 30, 2010
Source: US Treasury International Capital Reporting System

Display 2
Shifting Currency Choices



As of June 30, 2010
Source: Bloomberg, Haver Analytics and US Treasury International Capital Reporting System

the significant upsurge in the prices of equities, bonds, commodities and emerging-market assets in 2009.

China has also been a big driver in currency markets. Before the 2008 market panic, China's reserve managers had run a diversified investment program that had tended to buoy the euro. By using the proceeds from their US-dollar interventions to buy euros, they likely helped boost the value of the euro in US-dollar terms. Subtracting identified US-dollar assets from the rest of China's reported reserves indicates that China was steadily accumulating both US-dollar- and euro-denominated assets (**Display 2**).

After Lehman's collapse, the panic-induced rush to accumulate US dollars, including Treasury bills, pushed up China's reserves in US dollars sharply, and the US dollar's value jumped in terms of euros. But sometime in early to mid-2009, it appears that China's reserve managers began trimming back their growing US-dollar bias, and reserves in the US currency stopped rising. By late 2009, identified US-dollar assets captured in the US Treasury reporting system had begun to decline. One contributor to that decision

may have been the opinion among Chinese leaders, as voiced at the time, that the US fiscal deficit had become a serious threat to long-term solvency.

By early 2010, of course, the spotlight had turned to Europe's sovereign-debt problems. China's shift back into euros may have seemed ill timed, and probably stopped for a while. US data offer no clues as to what investments, besides US-dollar assets, were attracting Chinese reserve managers' interest. But the euro's weakness in early 2010 suggests that Chinese funds were not flowing into euro-denominated paper. Judging from the volatile behavior of the euro over this period, it looks as though China's reserve managers have been putting their money elsewhere, including into the government bonds of South Korea, Japan and several emerging markets.

We can even use the US reporting system to gauge Chinese buying of non-US assets through US dealers. The reporting system captures these trades, although we cannot tell which countries the assets came from. What we can determine is that China's reserve managers consistently accumulate non-US assets from US dealers whenever

global risk appears to diminish. They stop periodically, whenever risk rises—as they did most recently during the European sovereign-debt scare—but never reverse old positions. Such systematic on-and-off buying may be exacerbating the risk-on, risk-off behavior of the global markets.

Recently, questions arose when a drop in China's US Treasury bill holdings in May was followed by its sale of US Treasury bonds in June. China may have accelerated the drawdown of US dollar assets to finance a program to buy higher-return US and emerging-market assets, which are not captured in the US Treasury reporting system. If so, it may signal that the reserve managers were a bit too ambitious with their new buying program. Reserve accumulation has slowed to about US\$10 billion a month this year, while the mountain of US T-bills has fallen to zero.

The overarching impression we get from the US Treasury data is that China's portfolio managers are quite risk-averse, and tend to react sharply to unexpected developments. In some cases, their actions may have actually amplified the global market volatility of the past few years. ■

The information contained here reflects the views of AllianceBernstein L.P. or its affiliates and sources it believes are reliable as of the date of this publication. AllianceBernstein L.P. makes no representations or warranties concerning the accuracy of any data. There is no guarantee that any projection, forecast or opinion in this material will be realized. Past performance does not guarantee future results. The views expressed here may change at any time after the date of this publication. This document is for informational purposes only and does not constitute investment advice. AllianceBernstein L.P. does not provide tax, legal or accounting advice. It does not take an investor's personal investment objectives or financial situation into account; investors should discuss their individual circumstances with appropriate professionals before making any decisions. This information should not be construed as sales or marketing material or an offer of solicitation for the purchase or sale of any financial instrument, product or service sponsored by AllianceBernstein or its affiliates.

Note to Canadian Readers: AllianceBernstein provides its investment management services in Canada through its affiliates Sanford C. Bernstein & Co., LLC and AllianceBernstein Canada, Inc.

Note to UK Readers: UK readers should note that this document has been issued by AllianceBernstein Limited, which is authorised and regulated in the UK by the Financial Services Authority. The registered office of the firm is: Devonshire House, One Mayfair Place, London W1J 8AJ.

Note to Australian and New Zealand Readers: This document has been issued by AllianceBernstein Australia Limited (ABN 53 095 022 718 and AFSL 230698). Information in this document is intended for wholesale investors only, and is not to be construed as advice.

Note to Readers in Vietnam, the Philippines, Brunei, Thailand, Indonesia and India: This document is provided solely for the informational purposes of institutional investors and is not investment advice, nor is it intended to be an offer or solicitation, and does not pertain to the specific investment objectives, financial situation or particular needs of any person to whom it is sent. This document is not an advertisement and is not intended for public use or additional distribution. AllianceBernstein is not licensed to, and does not purport to, conduct any business or offer any services in any of the above countries.

Note to Readers in Malaysia: Nothing in this document should be construed as an invitation or offer to subscribe to or purchase any securities, nor is it an offering of fund management services, advice, analysis or a report concerning securities. AllianceBernstein is not licensed to, and does not purport to, conduct any business or offer any services in Malaysia. Without prejudice to the generality of the foregoing, AllianceBernstein does not hold a capital markets services license under the Capital Markets & Services Act 2007 of Malaysia, and does not, nor does it purport to, deal in securities, trade in futures contracts, manage funds, offer corporate finance or investment advice, or provide financial planning services in Malaysia.

Note to Singapore Readers: This document has been issued by AllianceBernstein (Singapore) Ltd. (Company Registration No. 199703364C). The Company is a holder of a Capital Markets Services Licence issued by the Monetary Authority of Singapore to conduct regulated activity in fund management.

Note to Taiwan Readers: This information is provided by AllianceBernstein funds Taiwan Master Agent, AllianceBernstein Taiwan Limited. SFB operating license No.: (97) FSC SICE no. 049. Address: 57F-1, 7 Xin Yi Road, Sec. 5, Taipei 110, Taiwan R.O.C. Telephone: 02-8758-3888. AllianceBernstein Taiwan Limited is a separate entity an independently operated business.

Note to Hong Kong Readers: The document has not been reviewed by the Hong Kong Securities and Futures Commission. The issuer of this document is AllianceBernstein Hong Kong Limited.