



Debt – Whose problem is it?

“If I owe you a pound, I have a problem, but if I owe you a million, the problem is yours” – John Maynard Keynes

“China ‘worried’ about U.S. Treasury holdings”, this was the headline on 13 Friday March 2009 that highlighted China’s concerns on the safety of its holdings of U.S. assets. As it stands, China is Washington’s biggest foreign creditor with an estimated US\$739.6 billion in U.S. government debt i.e. government bonds as at end-January 2009. Without turning this into a finance lecture, a government bond is a debt instrument that is issued by a country’s government promising a stream of interest payments to the holder of the bond plus a final repayment of principal. It should come as no surprise that during times of economic turbulence, the most sought after government bonds, as a risk-free investment, are those from the United States. U.S. bonds/treasuries remain one of the most widely held debt instruments by nationals and foreigners.

Bond issuances are commonly used to finance budget deficits by absorbing any excess liquidity in the market. In February 2009, the U.S. budget deficit stood at \$192.8 billion, up from \$86.5 billion the month before. Financing this deficit and boosting economic growth in the U.S. are high on the agenda of the Obama Administration as more and more propositions are made for stimulus packages by the billions. The latest move, at the time of writing, by the U.S. Treasury is a plan aimed at financing as much as \$1 trillion in purchases of distressed assets to help a still troubled financial system. With packages worth billions and trillions being thrown around, the Chinese are becoming increasingly worried about the possible erosion in value of the U.S. assets they hold as the issue of a weaker dollar arises.

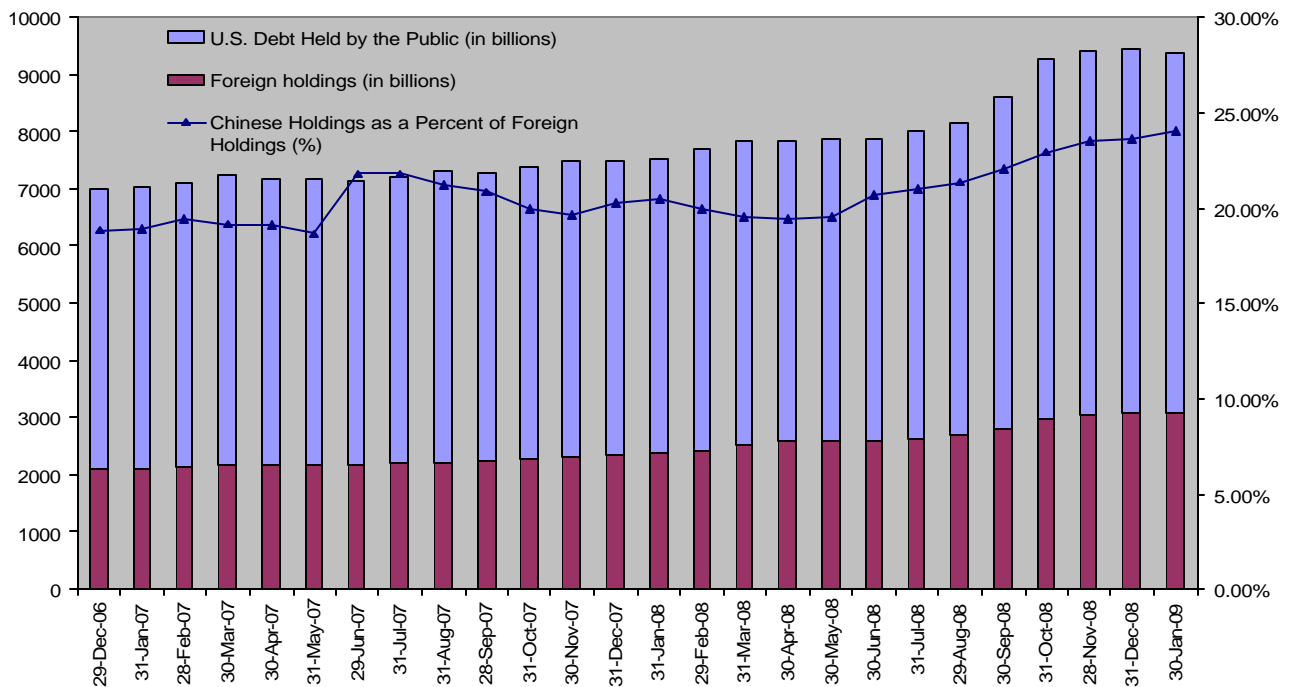
Long before the financial crisis erupted and even now, the U.S. dollar continues to be the world’s most widely used currency. Governments across the globe hold their reserves in dollars while crude oil and many other key commodities are priced and traded in dollars. The latest available data shows the value of China’s holdings in Treasuries and other U.S. government debt is estimated at \$740 billion. China has had growing concerns about relying on the dollar for the bulk of its trade and its foreign reserve holdings and has called on the U.S. administration to avoid any response to the crisis that might weaken the dollar. They have even gone so far to say that the International Monetary Fund (IMF) should aim to “create a non-sovereign reserve currency” in the long-term. The recommendation by China’s Central Bank governor is the creation of a currency made up of a basket of global currencies that is controlled by the IMF which would help “to achieve the objective of safeguarding global economic and financial stability”.

The financial crisis has highlighted once more the importance of the U.S. economy and how its problems trickle down to the rest of world. It all boils down to the main theory of economics, supply and demand and by extension, trade. China exports around 20% of its goods to the U.S., its main trading partner and this factor of GDP has definitely felt the brunt of

the global slowdown. The biggest decline in Chinese exports in more than 10 years was seen in February with exports falling by 25.7%, year on year. To counter this fall, like the U.S., China has boosted investment spending pouring money into roads, railways and power grids. Fixed asset investment climbed 26.5% in January and February 2009 to a combined total of \$150 billion from a year earlier. China has also announced a \$585 billion stimulus package of tax cuts and infrastructure spending to achieve a target of 8% economic growth this year.

There is a saying, *"it takes two to tango"* - just as the Chinese economy relies on the U.S. for exports, the U.S. needs the Chinese. As the U.S. administration sells record amounts of debt to fund their stimulus packages, it is important that the main buyers of U.S. Treasuries, specifically China, keep buying.

Figure 1: U.S. Total Public Debt Outstanding



As seen from Figure 1, U.S. debt held by the public has been increasing and this is most evident from August 2008. This debt does not include intragovernmental holdings which are Government Account Series securities held by government trust funds and the like. Taking these two factors into consideration, debt held by the public and intragovernmental holdings, this represents the total public debt outstanding which, to date, is over \$11 trillion.

Even with a debt figure this high, the U.S. remains one of the most highly rated sovereigns by rating agencies and many regard the economy as the safe haven for investments especially during financial crises. This leads us to ask the question, why? It is said that a traditional defense of the national debt is that the Americans "owe the debt to themselves". This means that the U.S. can easily print more money to finance their debt as it is denominated in the U.S. Dollar and the possibility of default is close to nil. With foreigners holding almost 50% of the U.S. debt held by the public, China being the largest holder, should these foreign holders, specifically China be concerned?

The answer is both yes and no and it has to do with the movement of the U.S. dollar and when the Chinese holdings of

U.S. debt are expected to mature. The dollar continues to react strongly to every move made by the U.S. administration to help bolster growth. The Treasury's recent decision to buy-back debt caused yields to fall as the supply of debt decreased which caused a rally in Treasuries. Contrary to what traditional economics teaches us, the response to this Treasury rally was a depreciation of the US dollar. The US dollar has since recovered. This was driven by the overwhelming demand for the 5-year notes at the \$34 billion auction held on 25 March. This only proves how highly sensitive and unpredictable the dollar can be in response to actions taken by the U.S. Treasury to help turn around the economy. In the short-term, the Chinese government should be concerned about the erosion in value of its U.S. holdings as they will lose out if they were to sell these assets now. In the long-term, should global demand recover, and credit availability improves, U.S. growth will once again be in positive territory and the demand for the dollar will increase thus appreciating in value.

As the quote says *"If I owe you a pound, I have a problem, but if I owe you a million, the problem is yours"*. This statement definitely holds true for the Chinese for now, but may change in the long-term. The main issue at hand besides the ups and downs of the dollar, is, can the U.S. government default? Research will tell us that the probability of this happening is low and as we see now, even with the U.S. at the height of economic turmoil, investors still turn to their assets for a safe refuge during times of uncertainty. The dollar will continue to be one of the world's most widely used currencies. This leaves us to wonder, is it inevitable that at least for a long time to come, the rest of the world will catch a cold as the U.S. sneezes?

FINANCIAL & ECONOMIC INDICATORS

As at 26 March, 2009

<u>Exchange Rate/US\$</u>	<u>Closing Value</u>	<u>Previous Week</u>
Yen	98.71	94.51
Euro	1.35	1.37
Jamaica	88.40	88.01
Guyana	206.00	205.20

<u>Commodity Prices</u>	<u>Closing Value</u>	<u>Previous Week</u>
Crude oil (US\$/bbl)	54.34	51.61
Natural Gas (US\$/mmbtu)	4.16	3.68
Gold (US\$/Troy Ounce)	934.10	959.85

Eurobond Indices (As at 26-March-09)

Lehman Brothers Global Aggregate Index (Return % YTD)	-2.74
JP Morgan EMBI+ (Basis points)	616
JP Morgan Central America and Caribbean Index (CACI) (YTD return %)	4.50

<u>Policy Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
United States	0-0.25	0-0.25
Euro Zone	1.50	1.50
Japan	0.10	0.10
Brazil	11.25	11.25
Trinidad	8.75	8.75
Jamaica	17.00	17.00
Barbados	3.00	3.00

<u>Market Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
US 90-day T-Bill	0.14	0.19
US 10-Yr Treasury	2.74	2.60
3-month UK Libor	1.70	1.76
Japan 90-day T-Bill	0.38	0.38
Brazil 90-day T-Bill	10.82	10.45
TT 90-day T-Bill	3.58	3.58
Jamaica 90-day T-Bill	20.51	21.69
Barbados 90-day T-Bill	3.85	3.84

Sources: Bloomberg, CMMB, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, www.lehman.com

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