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OPINION

Markets Insight

China's appetite for US assets imperilled at worst possible time

A shrinking Chinese current account surplus poses problems for US public and private sectors

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Trade tensions between Washington and Beijing have fixed all eyes on China's large goods trade surplus with the US. While the likelihood of an outright trade war is hard to gauge, largely overlooked is another threat arriving with near certainty from the world's second-largest economy — the end of China's large current account surplus. Without those large surpluses, China will probably cut back its purchases of US financial assets, just as Treasury bond issuance surges and corporate America needs to refinance more of its debt.

For the past 25 years, China has posted substantial surpluses on its current account (which is the balance of goods and services, plus net investment income). But years ahead promise relatively small surpluses or even deficits. This means that Chinese demand for US Treasuries and corporate bonds could stagnate, or even decline. The trade discussions, however, appear to have ignored the unfolding current-account deterioration, despite its negative implications for US fixed-income assets.

Broadly speaking, surpluses in a country's current account are synonymous with net inflows of foreign currency, also referred to as external savings. China has historically invested its external savings in global financial assets. In particular, China has shown an omnivorous appetite for US assets, including commercial real estate, corporate bonds, equities and, of course, Treasuries. But as its current-account surplus has weakened, China has gone on an asset-buying diet. The worrying thing for the US is that that calorie counting could turn into a hunger strike if surpluses give way to deficits.

Over the past decade, China's current account has fallen from a surplus of over 10 per cent of the country's gross domestic product in 2007 to just 0.4 per cent last year. In fact, the country's current account posted a small deficit in the first three quarters of 2018 before making up the shortfall in the fourth.

The shrinking of that surplus reflects China's transition from a low- to a middle-income country with the accompanying shift of its economy from an investment- to consumption-led model. As consumption has grown as a driver of growth, China has become a big importer of energy, soyabeans, aircraft and passenger vehicles from the US. Furthermore, as its economy has moved up the value chain, China has become a bigger consumer of higher-end products and services. In fact, China's services deficit totalled $230bn over the first three quarters of 2018, almost equal to the full-year services deficit of 2016.

One way for China to slow the decline in its current account would be to curb imports of these goods and services. But this runs counter to China's economic transition which is already under way. In fact, the US-China trade talks reportedly include offers by China to boost imports of American goods and services to meet the demands by President Trump to cut the large Chinese trade surplus.

Beijing also continues to prioritise foreign investment. Foreign investment into China has been primarily in higher-yielding assets compared with China's holdings of foreign financial assets. This has led China to pay out more than it receives in investment income, resulting in deficits on that component of the balance of payments. As the country continues to open its financial markets to foreign investors, investment-income deficits will probably grow.

The upshot of these trends is that China's current account weakness will probably endure well into the future. This will result in a structural decline in global liquidity as China draws down on its large net external savings to fund domestic consumption.

For decades, the large Chinese current account surplus allowed Chinese importers to recycle dollars received for sales of exported goods back into US financial assets. As a result, China became one of the largest holders of US Treasuries ($1.13tn as of January), US agency debt and US corporate debt, to say nothing of equities, real estate and other assets. As the current account surplus has shrunk in recent years, purchases of these assets by Chinese investors, both private sector and public, have fallen.

The US depends heavily on foreigners to buy its government debt and other financial assets. Foreigners own about one-third of Treasuries outstanding. Meanwhile, the Federal Reserve is cutting its holdings of Treasuries to reduce the size of its balance sheet. Against those headwinds facing demand, the issuance of US assets is headed higher. Estimates for net Treasury issuance in 2019 range from $1.3tn to $1.7tn, up from about $1.3tn last year.

Outside the Treasury market, US companies may need to roll over as much as $700bn of debt maturing this year and a similar amount in 2020. They, too, will face the challenge of doing so in the face of diminished Chinese demand.

While President Donald Trump has focused trade negotiations on the goods deficit and technology, Americans should be on the lookout for the second-order effects which must arise from any changes made on the trade front. US policymakers appear to have grown accustomed to a constant Chinese bid for US financial assets — a bid which may disappear just when government and companies need it most.

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