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Wary of U.S. debt, China shifts gears on investment

Tue May 19, 2009 8:23am EDT

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By Simon Rabinovitch - Analysis

BEIJING (Reuters) - China has engineered a subtle yet significant shift in the investment of its foreign exchange reserves, a sign of how it is willing to act on concerns about financing an explosion of U.S. debt.

Beijing has been far and away the single biggest foreign buyer of Treasuries over the past year, but this apparent vote of confidence belies how it has turned its back on long-term U.S. debt in favor of shorter maturities.

China's move to the shorter end of the U.S. debt spectrum is a defensive tactic adopted by the wider market as well on the view that the United States will have to raise interest rates down the road to control inflationary pressures when the economy recovers from the financial crisis.

But the shift also comes after pointed comments from Beijing expressing worries over the security of its U.S. investments and calls from Chinese government economists for a tough line with Washington in return for continued access to loans.

"The United States is making policy decisions purely according to domestic considerations and is giving little thought to the outside world," said Zhang Ming, an economist at the Chinese Academy of Social Sciences (CASS), a leading think-tank.

"This being so, the Chinese government should prepare its defenses," he said. "We can keep buying U.S. debt but we have to attach some conditions."

But China's leverage may be limited, despite sitting on the world's largest stockpile of foreign exchange reserves at \$2 trillion.

The very surge in U.S. debt -- the Treasury plans gross issuance this fiscal year of \$8 trillion -- means China's heavy buying is increasingly looking like a drop, albeit a very big one, in the ocean.

PLAY IT SHORT

Beijing has also taken pains to stress that, while uneasy about the U.S. economic outlook, it views Treasuries as a safe investment. And it knows that it would lose a lot from a plunging dollar with so much invested in the U.S. already.

So rather than cut off financing for the U.S.'s record budget deficit for this fiscal year, China has instead, little by little, shifted its buying out of longer-term bonds.

Between August 2008 and March 2009, China bought \$171.3 billion of bills, debt that carries a maturity of up to a year, compared with just

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\$22.9 billion of longer-term notes and bonds with a maturity of two years or more. It also sold \$23.5 billion of long-term agency debt, U.S. data shows.

That followed purchases of just \$9.6 billion of bills against \$47.8 billion of bonds and \$45.6 billion of agency debt in the first half of 2008.

For a chart showing China's short-term buying, click on:

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