China lectures Washington on S&P downgrade

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One of the sharpest reactions to last Friday's downgrade of US government debt by Standard & Poor's has come from China, the world's largest holder of US Treasury securities. A strident statement from the official state-run newsagency, Xinhua—criticising the US for living beyond its means—is a sign of China's vulnerability to the deepening US and international economic crisis and the consequent rise in tensions between the world's two largest economies.

Xinhua's statement, issued on Saturday, contained a blunt warning: "The US government has to come to terms with the painful fact that the good old days when it could just borrow its way out of messes of its own making are finally gone." It continued: "China, the largest creditor of the world's sole superpower, has every right now to demand the United States to address its structural debt problems and ensure the safety of China's dollar assets."

While not an official statement from the Chinese government, there is no doubt that Xinhua was expressing views widely held in ruling circles in Beijing. Last week in response to the deal in Washington to lift the US debt ceiling, China's central bank governor Zhou Xiaochuan urged the Obama administration to deal responsibly with its debt, warning that an unstable US bond market could undermine the international financial system.

Xinhua noted that S&P's decision had vindicated that of the Chinese credit rating agency, Dagong Global, to downgrade US sovereign debt from A+ to A. The newsagency commented that Dagong Global's move had been met by "arrogance and cynicism from some Western commentators" but S&P had now confirmed that its Chinese counterpart was simply "telling the global investors the ugly truth."

Xinhua insisted that the US must slash its "gigantic military expenditure and bloated social welfare costs." The reference to "bloated social welfare costs" underscores the complete contempt with which the regime in Beijing, like its capitalist counterparts around the world, holds the working class, whether in the US, China or anywhere else. Dagong Global went even further than S&P in demanding spending cuts—at least $4 trillion within the next five years.

As for the "gigantic military expenditure," successive US administrations have used American capitalism's residual military power to counter its economic decline. Under the Obama administration, the US has aggressively moved to counter China's growing international influence, particularly in Asia, and has no intention of cutting military spending.

Nor will Washington heed Xinhua's other proposals: for international supervision of the US debt, and for the establishment of an alternative world reserve currency as "an option to avert a catastrophe caused by any single country." Either measure would amount to what the US ruling elite regards as an intolerable limitation on its "right" to use the position of the dollar as the world reserve currency to expand debt with relative impunity.

Moreover, no other mechanism is able to take on the international role that the US dollar has played. Any move by China and other countries to establish alternatives would inevitably lead to a fracturing of the world monetary system into rival currency and trading blocs and a dramatic rise in economic tensions. Beijing is well aware that the results would rebound on the Chinese economy.

The Xinhua statement reflects nervousness over

China's vulnerability to the deepening economic turmoil in the US and Europe. China is the American government's largest creditor, holding $1.16 trillion in US Treasury securities. This is 12 percent of the Treasury's total publicly traded debt—greater than the 10 percent held by the US Federal Reserve Board. Any delay in interest payments, even temporary, would cause China to lose billions of dollars.

At the same time, China is in no position to enforce its demands for US fiscal responsibility. Xinhua adopts the stance of a hectoring bank manager speaking to a recalcitrant borrower, but Beijing cannot stop buying American debt, let alone start selling US bonds. That would only create an immediate panic in the market and a plunge in the value of US bonds.

More fundamentally, China, despite its efforts to diversify, remains dependent on its exports to the US and European markets. Its continuing purchases of US debt are bound up with the need to prevent the Chinese currency, the yuan, from rising in value against the dollar. Any downturn in Chinese exports, as happened at the height of the 2008-09 financial crisis, would lead to a wave of bankruptcies, soaring unemployment and—what Beijing fears above all—mounting social unrest.

Economic instability in China and the US are directly related. When Beijing pegged the yuan to the dollar in 1994 to keep its exports competitive, its foreign currency reserves, mainly from export earnings, rose rapidly. The Chinese central bank recycled dollars back to the US, which in turn allowed the US Fed to maintain the cheap credit policy that led to the orgy of speculation on Wall Street that eventually exploded in 2008.

In 2006, facing pressure from Washington, China allowed its currency to revalue within narrow limits, after its currency reserves surpassed $1 trillion. However, when the global financial crisis erupted, China re-pegged the yuan to the dollar, amid sharply falling exports and the sudden loss of an estimated 20 million jobs in export industries. Chinese currency reserves have since risen from $1.9 trillion in 2008 to the current level of $3.2 trillion.

Over 60 percent of China's foreign currency reserves are believed to be in dollar assets. Apart from Treasury bonds, China holds hundreds of billions in mortgage-backed securities such as those issued by the US government-controlled lenders, Freddie Mac and Fannie Mae, as well as private equities and bonds. The dollar assets held by China are now believed to total $2 trillion.

A Standard and Chartered report in June estimated that in the first four months of 2011, China's foreign reserves increased by $200 billion, with 75 percent invested in non-dollar overseas assets, especially in euro. As a result, China not only remains vulnerable to the instability of the dollar, but is increasingly exposed to the European economic crisis that threatens the existence of the euro as a unified European currency.

China has set up a $400 billion sovereign wealth fund to invest in global equity and bond markets, and provided finance to Chinese corporations to acquire overseas raw materials or foreign industrial assets. On a small scale, it has experimented with settling its foreign trade in yuan rather than US dollars. However, these moves are far too limited to resolve China's reliance on the purchase of US debt.

These economic processes have had serious ramifications within China. The central bank has had to issue huge amounts of yuan to buy the dollars and euros flowing from Chinese exports, which in turn has created massive liquidity in the Chinese banking system. As part of Beijing's stimulus measures, the state-owned banks made cheap credit easily available, helping to fuel a frenzy of speculation in construction and real estate. The Chinese government has been trying to rein in this speculation without triggering a disastrous economic slowdown or contraction.

All the while, the Chinese leadership is nervously watching the international reaction to the S&P downgrade of US debt and the European debt crisis, which have led to the largest stock market falls since 2008-09. Global financial instability could rapidly lead to a dramatic contraction of China's exports, collapse its property bubble and unleash explosive discontent in the Chinese working class.