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U.S. Debt to Asia Swelling

Japan, China Lead Buyers of Treasurys

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SHANGHAI -- Asia's largest economies are aggressively sinking the spoils of their trade surpluses with the United States into the purchase of U.S. government securities, financing much of the widening U.S. federal budget deficit.

Over the first six months of the year, Japan and China together purchased more than $96 billion in new U.S. government securities, according to Treasury Department data. Japan, the world's largest buyer of Treasurys, now owns a portfolio worth more than $440 billion, an amount greater than one-tenth of all outstanding issues. China, the world's second-largest buyer, owns more than $122 billion. Hong Kong, South Korea, Taiwan, Singapore and Thailand together own more than $166 billion.

While Japan has long been a hungry buyer of U.S. government debt, China's share has spiked dramatically in recent months as its reserves of U.S. dollars have grown, a result of China's increasing trade surplus with the United States and surging U.S. corporate investment in China. China's purchases of U.S. government securities rose 20 percent over the first half of this year and have increased by more than 150 percent since the beginning of 2002.

This flow of capital from Asia's central banks, which are the primary buyers of the securities, into the coffers of the U.S. Treasury supplies the Bush administration with a crucial artery of cash as it presses ahead with plans to pursue extended military operations in Iraq and Afghanistan, and as the federal government's budget deficit nears half a trillion dollars.

Moreover, foreign investment in the United States -- whether through buying Treasurys, stocks, real estate or other assets -- finances the much broader U.S. current account deficit, the amount by which Americans spend and invest more than they produce and save, or more generally the degree to which they go into debt to foreigners in order to live beyond their current means.

Should the day arrive when overseas holders of U.S. dollars, whether in Asia or elsewhere, decide not to buy so many U.S. assets or begin selling their holdings, that would reduce the overall demand for U.S. dollars, driving the value of the currency lower. That would raise the cost of imported goods in the United States, possibly fueling higher inflation and interest rates and slowing overall economic growth.

Economists have warned for years about the potentially painful consequences of such a shift in global investment patterns.

This has caused some analysts to even envision the day when China could use threats of selling Treasurys to try to influence U.S. economic or foreign policy -- for example to quash efforts by U.S. lawmakers to keep out Chinese exports or to pressure Washington to withhold support for Taiwan, the self-governing island that Beijing considers part of its territory.

"The U.S. dollar is now at the mercy of Asian governments," said Joan Zheng, a former official at the People's Bank of China, the country's central bank, and now an economist at J.P. Morgan Chase & Co. in Hong Kong. "If China wants to influence the market, it can. Its financial power is just so strong."

For now, though, most analysts view strong-arm tactics as extremely unlikely. If China really did sell Treasury securities, it might damage the U.S. economy, thereby harming the ability of American businesses and consumers to buy its goods. Key to the wealth that Asia is generating is its continued access to a healthy, growing U.S. market. Also, if China began to sell substantial amounts of Treasurys, that could be costly to China because it would drive down the value of its remaining Treasury holdings.

Altogether, $1.347 trillion worth of Treasury securities, more than a third of the total, were in foreign hands on June 30, according to Federal Reserve data released last week. Worldwide holdings of Treasurys by central banks rose about $51 billion in the first half of the year, which indicates that a substantial share of China's and Japan's central banks' purchases came as the result of selling by other central banks. Private holdings of Treasurys by foreigners increased by more than $80 billion, the figures show.

Asia's purchases of American debt are largely the result of the huge stocks of foreign exchange building up in the region as it claims larger pieces of global trade. Asia now holds about half the currency reserves on the planet, more than $1.5 trillion, according to FinanceAsia, a financial Web site in Hong Kong. By 2008, Asia will hold two-thirds of the world's reserves, according to a forecast by ING Barings. As much as 80 percent of this money is flowing into U.S. Treasurys because they have long been a haven for central banks seeking reliable returns.

Asia's role as financier of U.S. debt is peaking just as complaints grow in Washington about the very source of its wealth -- its soaring trade surpluses with the United States. China and Japan each have annual trade surpluses with the United States in excess of $100 billion.

The Japanese government also has massive amounts of dollars to invest because of its efforts to hold down the value of its currency, the yen, against the dollar, to boost exports to the United States. To do so, Japan's central bank used yen to buy billions of dollars this summer, but then it had to invest the dollars in U.S. assets.

China has pegged its currency -- the yuan, also known as the renminbi -- to the dollar for nearly a decade.

Manufacturers and labor groups in the United States have complained bitterly about what they say are undervalued currencies in Japan and China that effectively make those countries' goods unfairly cheap overseas. Some economists estimate the yuan is undervalued by as much as 40 percent, causing some U.S. business groups to blame China for the loss of millions of manufacturing jobs at home.

Some members of Congress have called for measures to force China to allow its currency to rise. But many analysts here construe such talk as largely political theater aimed at assuaging voters in key Rust Belt states ahead of next year's elections. Treasury Secretary John W. Snow recently visited Tokyo and Beijing, where he tread lightly, declining to complain about Japan's cheap currency while embracing as good news China's reiteration that some day -- not any day soon -- it plans to move toward a free-floating currency.

More than one factor explains the Bush administration's inclination toward the soft approach. Washington is counting on Tokyo's financial support for the war in Iraq, and it needs the cooperation of both Japan and China to try to coax North Korea back from the brink of developing nuclear weapons. The Bush administration also has learned that even if it does complain, China and Japan will probably pursue their economic self-interest anyway, maintaining lower currencies.

Special correspondent Akiko Kashiwagi in Tokyo contributed to this report.