Three Trillion: A Problem

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Actors and the Setting

- Cast : US, China, Other reserve currency countries-eurozone and Japan, ROW.
- Act I Selling the Bonds
- Scene 1 Beijing Meeting about US bonds
- Scene 2 New York The Bond Market
- Scene 3 The Exchange Market
- Scene 4 Frankfurt Bond Market
- Scene 5 Beijing and other capitals
- Act II Buying Bonds-Reserve Accumulation

Scene I Beijing

- Chinese authorities decide to sell of 1 T dollars of US Treasury Bonds.

Scene 2 : New York Bond Market

- Anti-Climax : Nothing happens. Past few years US issued 1.2 trillion dollars worth of bonds to fund deficit without a problem. Now deficit is down to 500 b so with a IT additional market should be able to absorb it.
- Chaos: Market collapses. Prices of bonds fall say 50%. China loses 500b of wealth. US gains 500b. Other holders lose wealth.
- Interest on US bonds increases.

Scene 3 Washington Budget Committees

- burden will increase because of higher interest.
- Let us buy back existing bonds at half price so total interest payments may change little and net effect on budget marginal.
- Important factor is how countries feeling poorer may react and tis will depend on why they have been accumulating reserves.
- Most importantly what do the Chinese do with the dollars.

Scene 4 Frankfurt bond Market

- Chinese invest in eurozone bonds.
- Will the shift from dollars to euros lead to a collapse of the market?
- Amounts involved are relatively small compared to the size of the market. But psychological effect would be important and difficult to predict.
- Nothing happens to yuan exchange rate but dollar depreciates and euro appreciates.

Effects of Exchange Rate Movements

- Helps reduce US CA deficit. US GDP rises.
- Will lower exports and economic activity in eurozone.
- Germany may react by slowing wage growth and so inflation.
- Increases pressure on South Europe and the Two Europe divide.

Scene 5 Beijing and other capitals

- Exports by developing countries to US increase as US GDP higher. Depreciation of dollar does not affect this as non-competitive goods.
- Effect on exports to eurozone ambiguous as GDP lower and exchange rate appreciates.
- Germany and others not affected.
- Southern countries compete and so affected by appreciation.

Scene 5 Contd.

- Chinese would increase savings, namely the CA surplus will rise.
- Others reserve value falls and poorer. increase savings, i.e raise surpluses reduces deficits.
- Eurozone deficits increase; two effects on US- lower deficits because of dollar depreciation vis-s-vis euro and higher because of other countries. Other countries larger surpluses.
- Net effect is likely to be greater imbalances.

Act II Chinese Reserve Accumulation Hurts others exports

- Reserve accumulation lowers yuan value.
- retains competitiveness of Chinese exports.
- These compete with exports of other developing countries .
- A depreciated yuan hurts exports of other developing countries.
- However, many developing countries also accumulating reserves preventing currency appreciation. Difficult to know net effect.