

# CHINA FLEXED ITS MUSCLES USING U.S. TREASURIES

The U.S. did a lot of hand holding with its biggest lender  
during the financial crisis



REUTERS/ANDY WONG/POOL

BY EMILY FLITTER  
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**C**ONFIDENTIAL DIPLOMATIC cables from the U.S. embassies in Beijing and Hong Kong lay bare China's growing

influence as America's largest creditor.

As the U.S. Federal Reserve grappled with the aftershocks of financial crisis, the Chinese, like many others, suffered huge losses from their investments in American

financial firms -- from Lehman Brothers to the Primary Reserve Fund, the money market fund that broke the buck.

The cables, obtained by WikiLeaks, show that escalating Chinese pressure prompted





**HANDSOFF:** China's Vice Premier Wang Qishan (R) and U.S. Treasury Secretary Timothy Geithner (L) try to shake hands while U.S. Secretary of State Hillary Clinton stands in the middle ahead of the opening ceremony of the China-U.S. Strategic and Economic Dialogue in Beijing May 24, 2010. **REUTERS/JASON LEE**

a procession of soothing visits from the U.S. Treasury Department. In one striking instance, a top Chinese money manager directly asked U.S. Treasury Secretary Timothy Geithner for a favor.

In June, 2009, the head of China's powerful sovereign wealth fund met with Geithner and requested that he lean on regulators at the U.S. Federal Reserve to speed up the approval of its \$1.2 billion investment in Morgan Stanley, according to the cables, which were provided to Reuters by a third party.

Although the cables do not mention if Geithner took any action, China's deal to buy Morgan Stanley shares was announced the very next day.

The two Treasury officials to whom the cables were addressed, Deputy Assistant Secretary for Asia Robert Dohner and

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Deputy Assistant Secretary for International Monetary and Financial Policy Mark Sobel, declined through a spokesperson to comment for this story. The State Department also declined to comment.

China is America's biggest foreign lender, playing a crucial role in the U.S. Treasury auctions that allow Washington to borrow what it needs to keep its government running. At the same time, the United States is China's top export destination: America's trade deficit with the nation reached a record \$273.1

billion in 2010. Most economists describe the two economies as co-dependent.

The concern in certain influential Washington and Wall Street circles is that Beijing would leverage its position as the main enabler of U.S. overspending. And the cables provide a glimpse into how much politics inform relations between the world's two largest economies.

One cable cites Chinese money managers expressing concern that U.S. arms sales to Taiwan -- a major, longstanding irritant in the relationship -- could sour the Chinese public on Treasury purchases.

The subject of Taiwan came up during an Oct. 9, 2008 meeting the U.S. financial attache's office had with Liu Jiahua, Deputy Director General of China's foreign currency reserve manager, the secretive behemoth known as the State Administration for

Foreign Exchange, or SAFE.

"Liu observed that the recent U.S. announcement of another arms sale to Taiwan made it more difficult for the Chinese government to explain its policies supportive of the U.S. to the Chinese public," reads an account of his comments in one of the cables.

The cables also indicate a high level of confidence among the Americans that China can't entirely stop buying U.S. debt, a sentiment shared by most economists who describe the dynamic as a form of mutually assured financial destruction.

But the cables do show that China can and will pull back, with financial repercussions. In the spring of 2009, with U.S.-China financial tensions running especially high, China's Treasury holdings fell to around \$764 billion, down from nearly \$900 billion. In July, after tensions between the two nations mostly subsided, its holdings rose to a record \$940 billion.

During the financial turmoil, the cables show that Beijing also shifted its portfolio away from longer-term Treasury notes, which helped drive up America's long-term borrowing costs.

#### NOT TOO BIG TO FAIL

THE COLLAPSE OF LEHMAN had a swift and powerful impact on SAFE. "Several interlocutors have told us that Lehman was a counterparty to SAFE in financial transactions and as a result SAFE suffered large losses when Lehman collapsed," Deputy Chief of Mission at the U.S. Embassy in Beijing Dan Piccuta wrote in a cable to Washington on March 20, 2009.

The hit to its balance sheet is likely what prompted a Chinese official to tell a U.S. diplomat months earlier that SAFE was afraid to re-enter the U.S. repo market -- that is, it was reluctant to resume lending its short-term Treasuries to counterparties wanting to use them as collateral in cash loans.

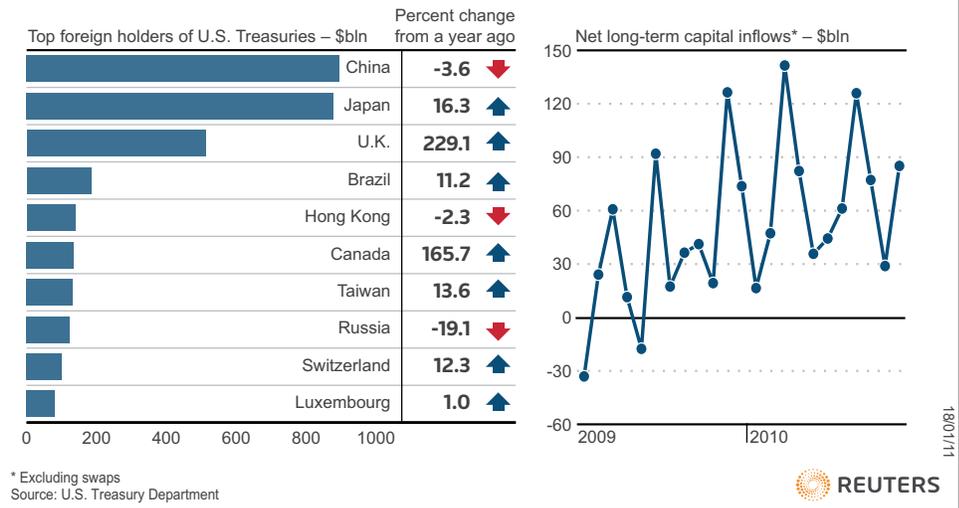
On Oct. 9, 2008, officials from the U.S. embassy's office of the financial attache in Beijing met with SAFE Deputy Director General Liu Jiahua. "SAFE is very concerned over the danger involved in lending U.S. Treasuries to U.S. financial institutions in the repurchase agreement market," Liu said.

Liu said SAFE's confidence in U.S. banks had been shaken. SAFE had exited the repo market, which is a way for corporations and financial institutions to borrow overnight.

The cable continues, "Liu remained noncommittal on the possible resumption of

## Foreign holders of U.S. Treasuries

In November, U.S. Treasuries bought by overseas investors rose to \$85.1 billion, driven by private investors. China, the largest investor in U.S. Treasuries, cut its holdings by 3.6 percent year-on-year.



Reuters graphic/Stephen Culp

*"SAFE IS VERY CONCERNED OVER THE DANGER INVOLVED IN LENDING U.S. TREASURIES TO U.S. FINANCIAL INSTITUTIONS IN THE REPURCHASE AGREEMENT MARKET!"*

lending, but agreed that SAFE had sufficient confidence in those institutions and would consider a system whereby the Federal Reserve or other U.S. government agency would act as a guarantor."

Public opinion clearly rattled China's financial leaders. One cable shows Liu citing an internet discussion forum, saying "the Chinese leadership must pay close attention to public opinion in forming policies."

The U.S. government does not appear to have offered the Chinese a special setup guaranteeing U.S. banks. Instead, the cables show, American diplomats reassured the Chinese by pointing out that Washington had infused banks' balance sheets with \$700 billion in fresh capital, effectively propping up the banking system.

#### FANNIE AND FREDDIE, GUARANTEED OR NOT

CHINA HOLDS HUNDREDS of billions of dollars in debt issued by Fannie Mae and Freddie Mac, the housing agencies known as Government Sponsored Entities, or GSEs.

Like many other investors, it purchased agency debt before the crisis with the expectation that Fannie and Freddie were implicitly backed by the U.S. government.

In Sept. 2008, when the Treasury Department took control of the two GSEs, SAFE officials grew alarmed, the cables show. Suggestions that senior GSE debt holders would have to take a haircut sparked a public outcry in China. The media warned that the government's currency manager faced monstrous losses similar to those suffered earlier by the nation's sovereign wealth fund, China Investment Corp., after its investments in U.S. financial institutions blew up.

Media outlets had already heavily criticized the government for CIC's losses -- a Financial Times story circulated by outlets such as China Daily speculated that CIC had lost \$80 billion of the government's foreign reserves. In late 2008 Chinese newspapers routinely ran headlines with the words "Fannie Mae" and "Freddie Mac" spelled out in English.

To defuse the situation, the Treasury Department sent Undersecretary for International Affairs David McCormick to Beijing for two days in October 2008. The gesture went over well.

"All of Undersecretary McCormick's

## "ALL OF UNDERSECRETARY MCCORMICK'S COUNTERPARTS APPEARED TO APPRECIATE HIS WILLINGNESS TO COME TO BEIJING IN THE MIDST OF A FINANCIAL CRISIS."

counterparts appeared to appreciate his willingness to come to Beijing in the midst of a financial crisis," Piccuta wrote in a cable dated Oct. 29, 2008. "Interlocutors stressed that unless leaders' concerns about the viability of banks and U.S. government-sponsored enterprises (GSEs) are assuaged, lower-level officials will be constrained from taking on greater counter-party risks."

The cables show McCormick trying to reassure the Chinese. "In each meeting, Undersecretary McCormick emphasized that even though the U.S. government did not explicitly guarantee GSE debt, it effectively did so by committing to inject up to \$100 billion of equity in each institution to avoid insolvency and that this contractual commitment would remain for the life of these institutions," Piccuta wrote.



**MONEY MEN:** (left) Chang Zhenming, Chairman and Managing Director of Citic Pacific, attends a news conference in Hong Kong August 26, 2009. **REUTERS/TYRONE SIU** (right) Xie Xuren, China's finance minister, attends a delegate reception in the G20 Finance Ministers and Central Bank Governors meeting at Gyeongju October 22, 2010. **REUTERS/KIM JAE-HWAN/POOL**

### PACIFIC RIFT

THE U.S. FEDERAL RESERVE announced a program to buy agency mortgage-backed securities and Treasuries in early 2009 to help flood the financial system with liquidity and stop Treasury yields from rising. But at first the purchases had very little impact on yields, which climbed steadily while the Treasury Department's auctions of new debt wobbled.

In China, top officials began publicly criticizing the inflationary side-effects of the Fed's program. They said the expansion of the Fed's balance sheet would devalue their Treasury holdings -- and indeed, the Chinese public watched as Treasury yields rose and the older debt the Chinese had sank in value.

On March 13, 2009, Chinese Premier Wen Jiabao said at a press conference he was "concerned" about the security of China's investments in U.S. Treasuries. The March 20 cable, titled "Premier Wen's comments on U.S. Treasuries: Protect China's investments," documents a score of Chinese officials discussing their worries about U.S. Treasuries and the potential consequences of their uncertainty.

One economist at Caijing Magazine, which diplomats described as a "respected" Chinese outlet, told U.S. officials in late February "there has been a 'huge debate' within the government about China's holdings of U.S. Treasuries."



**DEEP POCKETS:** Lou Jiwei, Chairman and CEO of China Investment Corporation, addresses the Asian Financial Forum in Hong Kong January 20, 2010. **REUTERS/BOBBY YIP**

According to the cable, the Chinese economist told U.S. embassy officials that "SAFE has been shifting its portfolio toward shorter-term assets to reduce the risk of capital losses from higher inflation."

That information dovetailed with data, released many months later, showing the Chinese had indeed sold longer-dated Treasuries and bought more T-bills, which

surged to \$210 billion by May 2009. The move likely contributed to the rise in long-term yields.

### GEITHNER IN BEIJING

TENSIONS REMAINED HIGH during Geithner's visit to China -- his first as Treasury Secretary -- on June 1 and 2, 2009.

Geithner, who has lived in China and

other parts of Asia and holds a master's in East Asian studies, met with top Chinese officials, including the head of CIC, China's \$200 billion sovereign wealth fund, and the ministers of finance and commerce.

The trip had been scheduled for months with a predictable agenda, but the meetings were full of spontaneous discussion and frank complaints from the Chinese, the cables reveal.

Xie Xuren, China's minister of finance, met with Geithner on June 1 and "expressed concern about the potential for inflation and the long-term sustainability of U.S. budget deficits," according to a cable detailing Geithner's visit, dated June 17, 2009.

The next day, June 2, CIC Chairman Lou

Jiwei confided in Geithner that his fund had halted all new investments in 2008 after the financial crisis broke out, but had since scoped out a new stake in Morgan Stanley, the U.S. investment bank.

At the time of Geithner's visit, Morgan Stanley was planning a new share issue to raise funds to repay the government for the money it received during the financial crisis.

"Lou asked if it would be possible for the Fed to expedite approval of CIC's request that this investment be exempted from restrictions on investment by bank holding companies, as the customary two-week process for considering such exemption requests is too long to allow CIC to take advantage of this opportunity," according to the cable.

There's no record in the cable of how Geithner responded, but it was only a day later, on June 3, that CIC announced plans to purchase \$1.2 billion in Morgan Stanley shares.

A spokesperson for the Fed said in the instance of the June 3 CIC investment, no application for an exemption was made to the Federal Reserve Board.

(Additional reporting by Kristina Cooke and Mark Hosenball; Editing by Jim Impoco and Claudia Parsons)

#### FLAGGING

**DIPLOMACY:** U.S. President Barack Obama and Chinese President Hu Jintao preside over a meeting with business leaders in the Eisenhower Executive Office Building at the White House in Washington, January 19, 2011. **REUTERS/KEVIN LAMARQUE**



COVER PHOTO: U.S. Treasury Secretary Timothy Geithner arrives at the National School of Development of Peking University in Beijing June 1, 2009. **REUTERS/ANDY WONG/POOL**

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