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Does the Pullback in the Bond Market Matter?

Maria A. Arias, Senior Research Associate
Paulina Restrepo-Echavarria, Economist

The supply of U.S. Treasuries has increased significantly since 2008, and central banks have been one of the most reliable sources of demand. However, several central banks with larger holdings of U.S. government debt have reduced their Treasury holdings for three straight quarters. Is the bond market at a tipping point? If so, is there cause for concern?

> Foreign demand for U.S. Treasuries might be crucial in keeping a cap on U.S. borrowing costs.

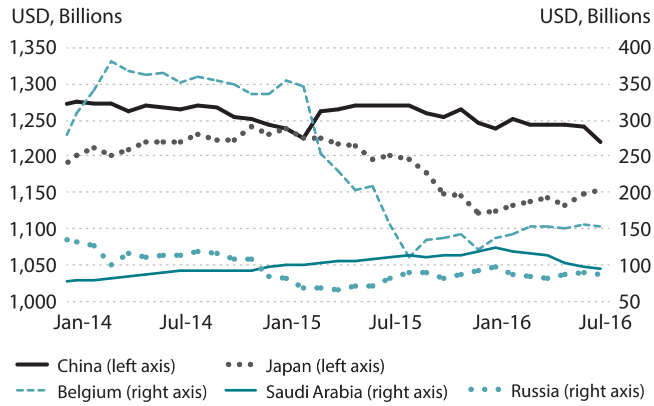
The Federal Reserve's custody holdings of U.S. Treasury securities for foreign central banks and other international institutions more than doubled between 2008 and 2013 and remained stable at around $3 trillion USD between early 2013 and mid-2015.[1] However, the official holdings dropped by $116 billion between June 2015 and June 2016, and then by an additional $93 billion between June and September 2016.

As of July, China and Japan were the top-two foreign holders of U.S. Treasuries, together owning 38 percent, while Belgium, Saudi Arabia, and Russia together held 5 percent. Figure 1 shows that all of these governments have recently reduced their exposure to U.S. Treasuries.

Each country has pulled back for a different reason. China has been selling U.S. Treasuries to defend the yuan against capital outflows due to slower growth. Japan has been swapping U.S. Treasuries for cash and T-bills because prolonged negative rates have increased demand for dollars. Saudi Arabia has been selling U.S. Treasuries to cover its budget deficit after the fall in oil prices. Euroclear Bank SA, based in Belgium, holds securities on behalf of other countries. Analysts speculate that it reduced its U.S. Treasury holdings on behalf of China.

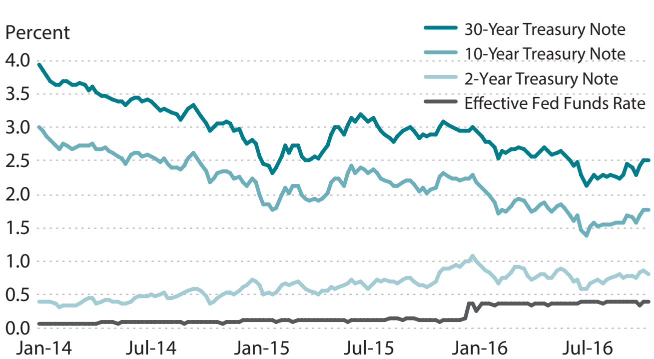
Although custody holdings have been dropping since mid-2015, U.S. Treasury yields had remained more or less

Figure 1
Select Countries with Declining Holdings of U.S. Treasuries



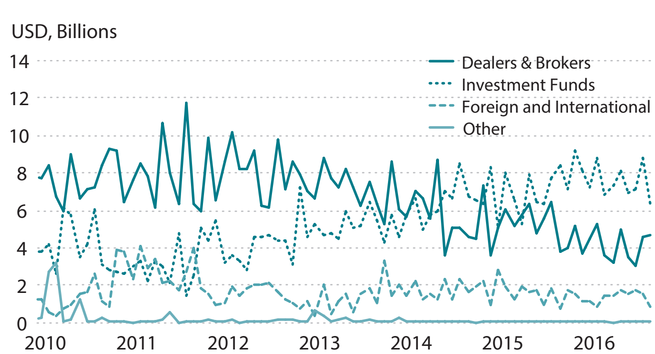
SOURCE: U.S. Treasury.

Figure 2
U.S. Treasury Yields



SOURCE: Board of Governors of the Federal Reserve System.

Figure 3
30-Year Treasury Note Auction Allotments



SOURCE: U.S. Office of Debt Management.

stable. In the face of larger sell-offs, however, the yields on the 30-year, 10-year, and 2-year Treasury notes rose by 38, 40, and 28 basis points, respectively, between the week ending July 6, 2016, and the week ending October 12, 2016 (Figure 2).

If the increase in yields is a result of the pullback, then foreign demand might be crucial in keeping a cap on borrowing costs. This implication is especially important if the U.S. national debt increases by $9 trillion over the next decade as projected.[2] On the bright side, however, other sources, such as investment funds, have increased their purchases of new U.S. Treasuries (Figure 3).

Will this increased demand from alternative sources compensate for the drop in demand from foreign central banks and keep yields low? Will demand from foreign central banks pick up again? If neither occurs, then the cost of debt might increase greatly and a likely increase in the federal funds rate won't help. ■

References

Bloomberg. "China Hides Treasury Buys in Belgium: Chart of the Day." July 27, 2014. Accessed October 18, 2016; http://www.bloomberg.com/news/articles/2014-07-27/china-hides-treasury-buys-in-belgium-chart-of-the-day.

Congressional Budget Office. "An Update to the Budget and Economic Outlook: 2016 to 2026." August 2016; https://www.cbo.gov/publication/51908.

Notes

[1] Custody holdings are securities kept on behalf of some client, such as a foreign government or central bank.

[2] An August 2016 Congressional Budget Office report projects public debt will be $14 trillion at the end of 2016 and $23 trillion at the end of 2026 (76.6 percent and 85.5 percent of GDP, respectively).

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