The Big Read **Chinese economy**

How China is quietly diversifying from US Treasuries

As investors become increasingly anxious about US government bonds, Chinese officials are looking for ways to reduce their exposure

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Earlier this year, a headline caught the eye of the senior officials at China's foreign exchange regulator who manage the country's multitrillion-dollar reserves: the Trump administration had overhauled the boards of Fannie Mae and Freddie Mac.

The officials responded swiftly, instructing a team at the State Administration of Foreign Exchange to kick off an evaluation of the potential investment implications of the shake-up.

The review included a deep dive into both government-backed mortgage consolidators, which bundle home loans made by commercial banks into securities that are sold to investors. They were nationalised by the US government during the financial crisis, but Donald Trump is reportedly considering returning them to private ownership.

What intrigued the officials at Safe, according to people familiar with the matter, is that they saw mortgage-backed securities — which come with an implicit US government guarantee — or even equity stakes in Fannie and Freddie themselves, as possible alternatives to Treasuries.

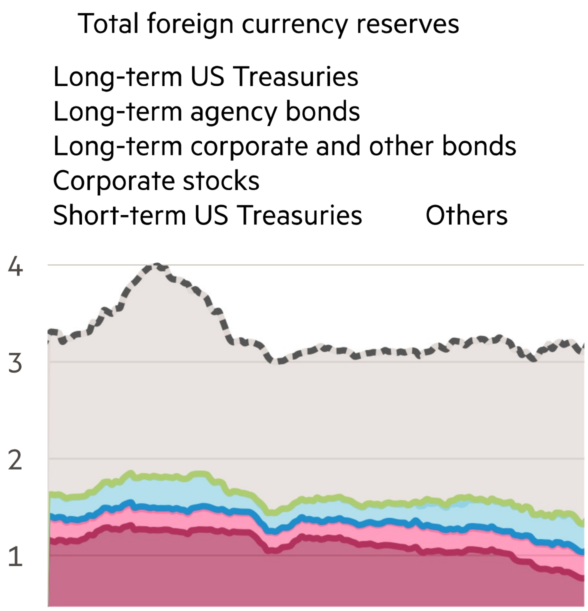
US government bonds have long formed the bedrock of China's $3.2tn in foreign reserves. So far, there has been no public indication of a change in that strategy, despite the imposition of tariffs and other gyrations in US policy.

Zou Lan, vice-governor of the People's Bank of China, told a briefing this week that the investment portfolio was already effectively diversified and that "the impact of fluctuations in any single market or single asset on China's foreign exchange reserves is generally limited".

US securities dominate China's $3.2tn of foreign exchange

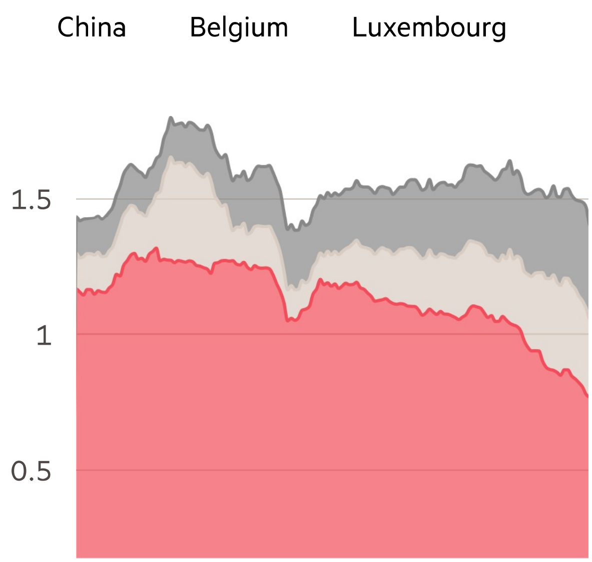
Total US Treasuries held by China, Belgium and reserves

China's foreign currency reserves, by *holdings of US securities and others ($tn)



Luxembourg have remained stable

Holdings of US Treasuries ($tn), *by country



Source: China's State Administration of Foreign Exchange, Federal Reserve Board • Data as of Dec 2024. *China may hold additional US Treasuries via custodial accounts in Belgium and Luxembourg

But many advisers, scholars and academics are voicing concern. “The safety of US Treasuries is no longer a given,” said Yang Panpan and Xu Qiyuan, two senior fellows at the Chinese Academy of Social Sciences, in an article in April. “That era is behind us, and we should be concerned about that change from the safeguarding perspective of our Treasury holdings.”

As Trump unravels the global trade system and publicly criticises the Federal Reserve, investors more widely are starting to question the haven status of the dollar and Treasuries.

The April sell-off in US Treasuries following Trump’s announcement of sweeping tariffs on America’s trading partners fuelled a long-standing fear in Washington and elsewhere: that China could attack the US by revenge-selling its Treasuries. Doing so could trigger alarming volatility in an asset coveted by central banks, asset managers and pension funds around the world for its stability.

But officials with knowledge of Safe’s workings say the agency does not regard massive dumping as a sensible option, preferring a gradual transition from Treasuries to other short-term assets and gold over a period of years.

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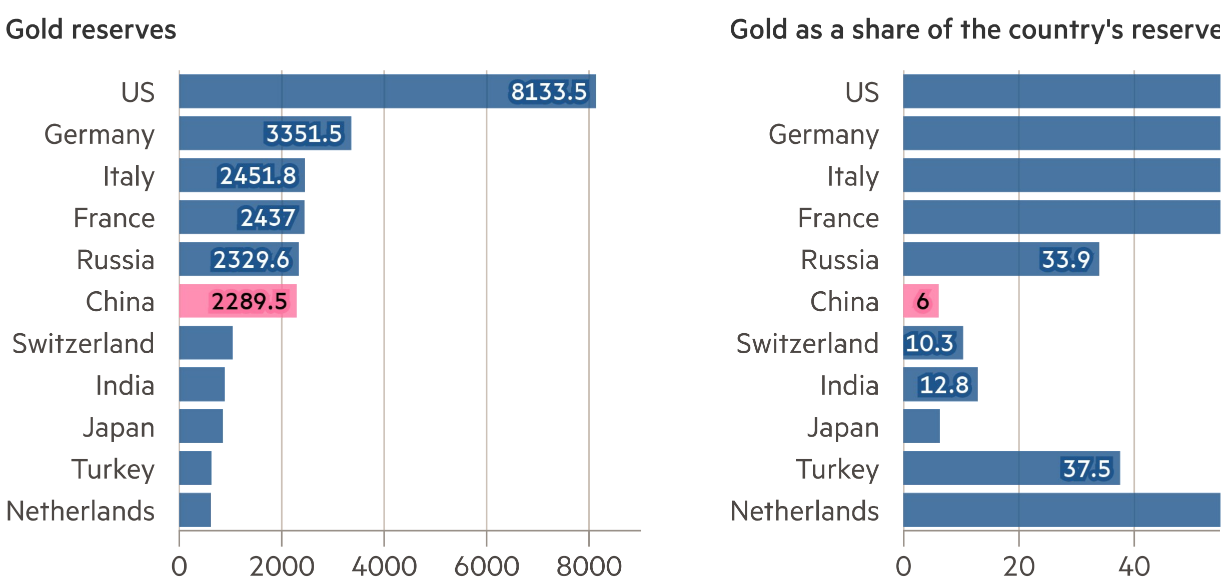
That process is described by one person close to Safe as “*tengnuo*”, a Chinese phrase that translates as “agile manoeuvring on a tightrope”. It aims to strike a balance between asset liquidity, safety, and stable if unspectacular returns.

Yet the volatility and unpredictability of policymaking in Washington presents a problem for a slow-moving Safe, with some arguing that *tengnuo* now looks increasingly unsustainable.

China ranks sixth in gold holdings, yet gold comprises only 6% of its reserve assets

Gold reserves (tonne) and gold's share of official reserves (%), by country



Source: World Gold Council • US, Russia and Switzerland data as of January 2025; others as of February

“I am deeply worried that the ongoing US-China trade dispute could spill over to China’s foreign assets,” said Yu Yongding, a former member of the Monetary Policy Committee at the People’s Bank of China and a senior adviser to the government, at a conference in early April.

He cited media speculation about a “Mar-a-Lago accord” along the lines of the 1985 Plaza Accord. Based on an essay by Stephen Miran, now chair of Trump’s Council of Economic Advisers, the aim of such a plan would be to weaken the dollar and persuade other governments to swap their Treasury holdings for 100-year zero-coupon bonds in return for more lenient trade tariffs.

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Few in financial markets believe this plan will ever be implemented. But for Yu, it is still a concern. Such a swap would constitute a default, he argued. “That poses a huge threat to China, and we may end up paying a steep price,” he added.

Beijing’s heavy exposure to dollar assets is a legacy of its export-driven economic boom and decades-long trade surplus with the west.

As overseas consumers spent trillions on the manufactured goods pouring out of China’s factories, the dollars that flowed the other way were often recycled into Treasuries — helping Washington to finance its budget deficit.

Window washers clean the Fannie Mae building in Washington. From 2018-20, China’s holdings of US agency bonds issued by government-sponsored entities rose 60 per cent © Andrew Harrer/Bloomberg

China’s dollar-denominated reserves peaked at nearly $4tn in 2014, according to central bank data, and have remained above $3tn since 2016. Despite their relatively low returns, Treasuries accounted for much of the pile because they were safe, liquid and (unlike gold) offered some yield.

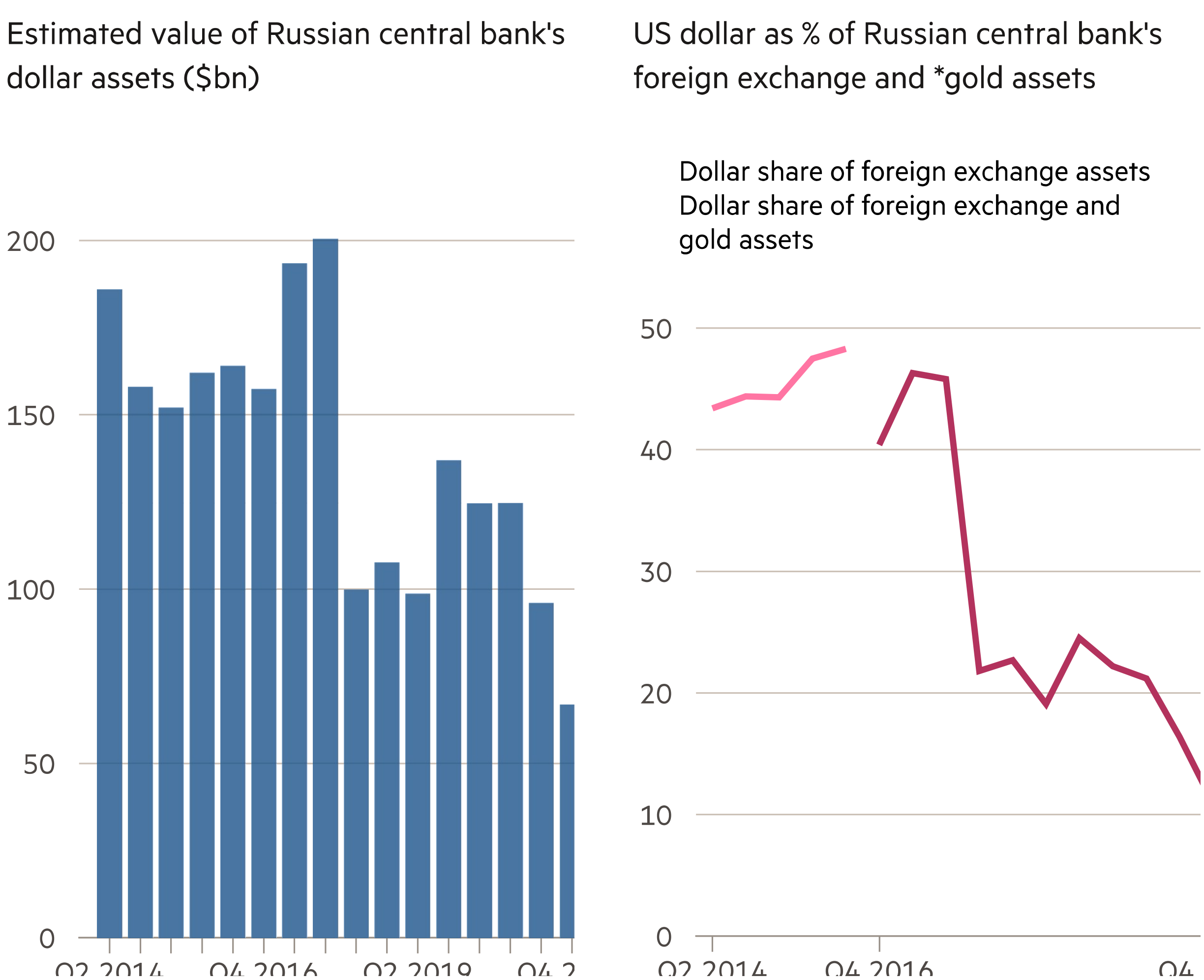
Safe data shows dollar assets were at 60 per cent of its total reserves from 2014 to 2018. Cross-referencing with US figures suggests the bulk of those assets were in Treasuries.

More recently, the limitations of such a Treasury-heavy portfolio have become more evident. Vast, concentrated holdings of low-return assets "may suffer significant purchasing power losses in a higher inflation environment", notes Yu Qiao, a professor at Tsinghua University and government adviser.

Safe began to shift the composition of its dollar-denominated portfolio in 2017 and the pace picked up after Russia's full-scale invasion of Ukraine in 2022. Even though Moscow had reduced its dollar-denominated reserves since annexing Crimea in 2014, Chinese officials saw how easily Russia's overseas dollar assets were frozen — and worried that, in the event of a serious confrontation with the US, China's much larger holdings could face a similar fate.

Scholars including Pan Liu and Zhang Weiwan from Tsinghua University warned in a 2024 research paper that the freezing of Moscow's overseas assets "is a stark reminder of the financial hegemony the US wields through the dollar-based international system", and that "the lesson for China is clear".

The Russian central bank has reduced its dollar assets



Source: Bank of Russia, FT calculations • *From Q4 2016 onwards, the dollar share is calculated using both foreign exchange and gold assets

Between January 2022 and December 2024, China cut its official Treasury holdings by more than 27 per cent to $759bn, US Treasury department data shows, far outpacing the 17 per cent decline between 2015 and 2022.

One strategy has been to increase holdings in so-called agency bonds issued by government-sponsored entities such as Fannie Mae. These offer similar credit ratings to Treasuries, but slightly higher yields. Between 2018 and early 2020, China's holdings of US agency bonds rose 60 per cent to $261bn.

"Clearly, agencies are the obvious substitute in the US market for Treasuries," says Brad Setser, a senior fellow at the Council on Foreign Relations. "[Safe's] general interest in agencies is well known, more so than most major central banks."

Safe also ventured into the private equity market. Through Rosewood Investment Corp, its discreet private investment arm based in New York, the agency has explored higher-yielding US assets, from private equity to commercial real estate and infrastructure such as data centres.

"We liked the return from investing in private equity when Treasury yields were low," says a person close to Rosewood. "It helped offset the low returns from government bonds."

Setser and others argue that China's real holdings of Treasuries could still be considerably higher than the reported totals, given its use of intermediary custodians such as Euroclear in Belgium and Clearstream in Luxembourg to mask direct ownership. Even so, the overall long-term Treasury position has gradually declined in recent years, they say.

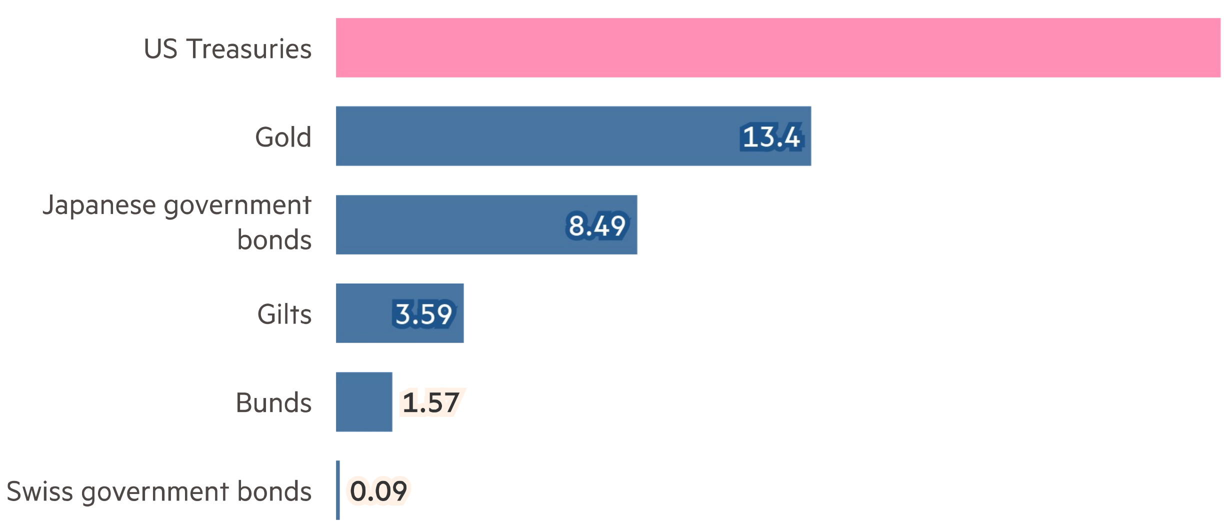
In other moves, Safe has shortened the duration of its US holdings and shifted to non-US asset managers. "That is to diversify risk at the execution level," says one European fund manager, who received Safe allocations previously managed by US firms this year.

More reserves are now being managed outside the US and other western countries where assets could easily be frozen. In January, Pan Gongsheng, governor of the People's Bank of China and supervisor for Safe, said it would "significantly increase" the allocation of the nation's reserves to Hong Kong.

While details remain sparse, some believe the move could expand to non-US assets in Asia — still denominated in dollars, but possibly issued by other countries and managed in places further from Washington's orbit.

US Treasuries are a much larger market than other haven assets

Market size ($tn), by asset



Source: US Department of the Treasury, Japan's Ministry of Finance, UK Debt Management Office, Deutsche Bundesbank, Swiss National Bank, World Gold Council, FT calculations • US Treasuries include all marketable Treasury securities outstanding. Gold refers to total above-ground stock, including bars and coins, gold-backed ETFs, central bank holdings, and other forms, excluding jewellery. Bond values are converted using exchange rates on Apr 30, and gold is estimated at $3,500 per ounce. Data as of Mar 2025 for US Treasuries and Swiss government bonds; Apr 2025 for gilts and bunds; and Dec 2024 for gold and JGBs

"The point is to fulfil multiple goals," one person familiar with Safe explains. "The agency needs to balance safety, returns and liquidity — and now, decoupling from the US."

The person adds that overall US exposure cannot be expanded further, given the desire to decouple, so if Safe sees value in mortgage-backed securities it cannot simply add them on top of its existing portfolios. "You need to sell long-dated Treasuries as they mature, and shift the allocation into MBS.

"By doing that you can in effect swap one US asset for another, and shorten the [overall] duration of the holdings."

Safe's gradual recalibration efforts received a jolt on April 2, when Trump unveiled his new tariff regime in the Rose Garden of the White House.

Markets around the world were rattled by the announcement of a 34 per cent blanket tariff on all Chinese imports, a figure later escalated to 145 per cent and not mitigated by the 90-day pause on "reciprocal" tariffs afforded to America's other trading partners.

Fears of a deepening rupture in US-China relations have left global investors asking whether trade disputes could spiral into financial confrontation, with Beijing using its vast holdings of Treasuries as a tool of retaliation.

Experts familiar with how Safe operates have largely dismissed this possibility, as have senior officials in Washington. "If the Federal Reserve believed that a foreign . . . rival were weaponising the US government bond market or attempting to destabilise it for political gain, I am sure that we would do something in conjunction with each other," said US Treasury secretary Scott Bessent in a recent interview. "But we just haven't seen that."

Any aggressive selling of Treasuries could be quickly neutralised by the Fed, which has a full set of tools including emergency quantitative easing to stabilise prices and push yields back down.

"That would just leave China selling into a falling market, but not really moving the needle [in the US]," says a former Safe official. Emergency selling of Treasuries is undertaken in some economies to raise money to defend the national currency, the official adds. Beijing did this in 2015 but has since changed its playbook. "China rarely intervenes directly in the spot [foreign exchange] market. It prefers tools like currency swaps or 'window guidance' through state-owned banks to manage the currency exchange rate."

Safe's reserves are managed without the use of borrowings, the former official notes, meaning that sudden liquidity pressures triggered by margin calls on leveraged positions are very unlikely.

That is in contrast to hedge fund strategies such as so-called basis trades, where high leverage is used to exploit small differentials between futures and cash market pricing, or the liability-driven investment strategies that caused ructions in the UK bond market in 2022.

Even so, China's positioning in the market is being closely watched by sovereign wealth funds, pension fund managers and other institutional investors.

A top executive at a large European pension plan says that, owing to the situation between the US and China, "it makes perfect sense for us to diversify into Europe and Canada . . . even though China may not do anything, the sheer idea of [China dumping US Treasuries] has introduced some kind of uncertainty, and that is new."

But in Chinese academic and policy circles, it is the suggestion of a selective US default that is most alarming — and some influential scholars are now advocating a move towards outright de-dollarisation, rather than gradual adjustments to the mix of dollar-denominated assets.

A range of proposals aimed at achieving this has been floated in recent months. They include boosting holdings of sovereign debt from other advanced economies, or using some of the reserves to shore up China's underfunded pension system. Currency diversification and larger gold purchases are also gaining traction.

"From a risk-hedging standpoint, currencies like the Swiss franc and Japanese yen are often considered safe havens," says Zerlina Zeng, senior director and chief Asia credit strategist at CreditSights. "But I don't see China going big on the yen, given Japan's close ties with the US."

China's central bank has been making 'moderate and uneventful' gold acquisitions, part of a strategy some see as an effort to strike a balance between asset liquidity, safety and stable returns © Ni Lifang/VCG/Getty Images

Instead, Zeng says it "makes more sense for China to increase its gold holdings". After three years of almost no growth, official data shows a sharp 18 per cent increase in the volume of China's gold holdings since late 2022. Gold now accounts for about 6 per cent of China's total reserves, up from just 2 per cent a few years ago.

"The reason a central bank would want to own gold is that it can be mobilised in a crisis," says James Steel, chief precious metals analyst at HSBC, adding that China's central bank is "doing exactly the right thing" by making "moderate and uneventful" gold acquisitions.

Safe has already scaled back its activities in US private markets. One Rosewood official says the firm had pulled back from tech-sector investments amid growing scrutiny of China-linked capital. "The notion of us taking even a modest stake in any US corporation is something the [Trump] administration is very reluctant to see us do," the official says.

A familiar problem with China's diversification attempts is that even significant asset classes such as Japanese, UK or German government bonds cannot match the vast liquidity of the Treasury market. Analysts warn that any substantial move out of US government bonds would have to be done very gradually, given the sheer size of China's holdings.

"That strategy is probably hitting its limits simply because there is a dearth of good quality [alternative] assets," warns Eswar Prasad, a professor at Cornell University who frequently speaks to Chinese regulators.

However, for Chinese policymakers the stakes are now too high to ignore and the search for non-dollar alternatives continues. "We may sacrifice some yields by investing in other countries' bonds," says a Beijing-based government adviser on China's foreign reserve management.

"But if conflict between the US and China escalates, sticking with the US Treasuries could mean us losing our entire [investment]."

Data visualisation by Haohsiang Ko

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