An Analysis on China's Foreign Exchange Structure Management

Tao Tian* and Dong Guangzhe**

Abstract

China's foreign exchange reserve had reached almost two trillion U. S. dollars by the end of March 2009. It is estimated that most remaining of China's foreign exchange reserve was used to buy U. S. bonds, especially the government-affiliated institutions or government guaranteed debt. Facing such huge numbers, with the situation of the dollar's continuous devaluation and China's economic growth rate slow down, how to manage foreign exchange reserves is becoming the focus of attention. This paper analyzes the problem and risk of China's foreign exchange reserve asset management, and put forward corresponding countermeasures and suggestions, which include clearing objectives, improving supervision and adjusting the stock and so on.

Keywords: Foreign exchange reserve, Asset structure, Management structure

I. Introduction

In recent years, the situation of world's foreign exchange reserve is changing significantly. The first is the scale is growing quickly. The world's foreign exchange reserve rose. Obviously, the increasing speed of developing countries' reserve assets were higher than that of developed countries'. The second is the currency of world's foreign exchange reserve and the pattern of asset structure had some changes[1]. After the Asian financial crisis, the foreign exchange reserve management which is closely related with external debt and foreign trade, especially the optimization of foreign exchange reserve's currency structure has been concerned widely, and gradually becomes one of the main problems of foreign exchange reserves. It is especially important to those developing nations which have a large number of foreign debts, and the vulnerable domestic financial systems.

From our point of view, China's foreign exchange reserve has been growing quickly since the foreign exchange system reform in 1994. China's foreign exchange reserve was rapidly growing since 2001, and it reached 853.6 billion U. S. dollars (USD), surpassing Japan and became the

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＊（陶　田）上海理工大学　管理学院教授　国際経済，投資経済
＊＊（董光哲）江戸川大学　経営社会学科准教授　経営資源の国際移転，中国企業経営行動論，アジア企業経営論

largest foreign reserve holder nation in the world by the end of February 2006. Since then, Chinese foreign exchange reserves continued to show a growing trend. Foreign exchange reserves in China has exceeded the total of world's leading Group of Seven (including the United States, Japan, Britain, Germany, France, Canada, Italy, referred to as G7) in April 2008. The amount of foreign reserve reached almost two trillion U. S. (USD), in the end of 2008, the accumulation rate is much higher than other developing countries, China also becomes the country which has the fastest growth rate of foreign exchange reserves, the proportion of Chinese foreign exchange reserve accounted for 28.99 percent in the world's, and in developing countries, the proportion sharply rose from 10.03 percent to 45.81 percent, this indicated that the developing countries' foreign exchange reserve present the trend that they would concentrated toward China.

The high foreign exchange reserves enhance China's external payments, and build the confidence of the domestic and overseas countries in China's macro-economic policies and the Chinese Yuan (RMB) stability; it can also attract foreign capital, which could guarantee China to achieve stable macro-economic. However, with the rapid expansion of China's foreign exchange reserves, the high foreign exchange reserves also increased the cost of holding them and the potential risks.

The Chinese government haven't announced the composition of foreign reserves structure, but it is undeniable that U. S. dollar occupied an important position in China's foreign exchange reserves to a large extent, especially U. S. dollar bond. In May 2002, the Bank of International Settlements (BIS) analyzed the foreign liquidity of outside of China bank system and liquidation conditions in its quarterly report, especially in a certain column for the first time. According to the report, by 2001 80% of China's foreign exchange reserves and individual foreign exchange deposits were as U. S. dollars. According to the U. S. Treasury' report on April 30, 2008, by the end of June 30, 2007, China spent about 922 billion USD on U. S. equity and securities. Among them, 894 billion were spent on U. S. bonds; equals 67% of China's foreign exchange reserves in the corresponding period. In such situation, any change of U. S. dollar would affect the quality of China's foreign exchange reserves. Therefore, it became the most urgent task for Chinese government to adjust the currency structure of foreign exchange reserves to alleviate the depreciation of the dollar's exchange rate risks, as well as to increase its earnings while maintaining its safety and liquidity. This is also an important issues in the process of foreign exchange reserve management optimization[2].

II. Analyze the Problem of China's Foreign Exchange Reverse Asset Structure

There usually are two forms of holding foreign exchange reserves; monetary assets and non-monetary assets. In another word, possess the reserves in the form of currencies or in the form of financial, monetary, and physical asset expressed by the reserve's currency. From the current situation of China's foreign exchange reserves asset management, it's easy to find that China had spent lots of its remaining foreign currencies to buy U. S. bonds, and most of them were U. S. treasury bonds, government-affiliated institutions or government guaranteed debt.

From this point of view, the questions are follow.

A. Low profit of foreign exchange reserves

For a long time, China's currency reserves are mainly USD, especially in the form of deposits and bonds, this could bring profits by its own. From the point of income, the revenue return of reserve ranged from 1% to 2% every year. In May 2002, the BIS quarterly report published that from 1999 to 2000; China had spent 80 billion USD on U. S. dollar bonds. According to the average of China's foreign exchange reserve in 1999 154.67 billion USD and that in 2000 165.574 billion USD, the proportion of U. S. bonds was about 49.96%; a part from buying U. S. assets and other purpose, the proportion of yen, Euros and other reserve currencies were much lower then 50%. After U. S. interest rate had been cut down for several times since 2001, the U. S. debt's profit was less than 1%; so income was very low.

It is showed from U. S. Treasury data that, by the end of June 30, 2007, China invested 922 billion USD in U. S. securities and capital that accounted for 60.33% of China foreign exchange reserve at that time, only inferior to Japan. However, look at China's investment of U. S. securities, the biggest problem was the low proportion. In the international invest cash table of 2007, published by State Administration of Foreign Exchange, Chinese government only invested 18.9 billion USD in foreign equity, while that was much lower than 16% of Japan, 47% of United Kingdom, and 72% of Canada[1].

By the end of June, 2007, the number of China's investment of U. S. long-term bonds had reached 871 billion 57% of the China foreign exchange reserves at that time. In these 50.65% spent on U. S. Treasury bond 40.78% on U. S. government debt, and 3.04% on U. S. corporate bond. Compared with other countries, the proportion of U. S. Treasury bond was much higher, as Belgium was only 3.53%, United Kingdom was 4.67%, and Japan was 46.2%[2]. Compared with U. S. agency bonds and corporate bonds, the U. S. Treasury bonds was safe but had lower rates of return, this indicated that China put more emphasis on security, while ignored profitability in terms of long term U. S. bond investment. It had the same situation of China's short-term U. S. bond investments; more emphasis on government debt, less on organ debt and corporate bonds.

Comparing the current benefits and opportunity costs, we have to pay attention to the negative impact of holding such huge scale of foreign exchange reserves. Therefore, the most important issue is to manage the structure of foreign exchange reserves, especially to choose the foreign exchange reserve' asset corporation reasonably, to improve foreign exchange reserves operational efficiency and, reduce the cost of holding foreign exchange reserves and increase the reserve assets returns.

B. Low management efficiency of foreign exchange reserves

Although the State Administration of Foreign Exchange Reserves has established relatively completed rules and regulations in practice, including post responsibility, trading regulations, system for settling account, accounting regulations, operation and management requirements,

1 Data sources: official website of State Administration for Foreign Exchange, International Investment Position of China.
2 Data sources: systemize according to Treasury Department's report on Apirl 30th, 2008.

statistical reporting system, financial management requirements, etc. However, such regulation for reserve asset management has not be established yet, there is still lack of an efficient operation mechanism. Before the establishment of China Investment Corporation, the State Administration of Foreign Exchange Reserves Division (SAFER) and its affiliated investment institutions mainly operated, the overseas investment of China's foreign exchange reserve. Compared with other financial asset management companies, as a public institution, the SAFER had problems of encouragement and punishment asymmetry. This was due to direct management of large amount of financial assets, while lack of relevant restrain and encouragement mechanism. As the government holds high proportion of reserves, the management of reserve assets lacks of flexibility, and thus it is difficult to combine safety, liquidity and profitability well. The China Investment Corporation founded on September 29, 2007, which actively engaged in three investments (Blackstone Group, H shares of Corporation of China Railway, and Morgan Stanley). As a result it, suffered a great loss instead of gaining profits because of the bad timing when it entered the market. Surely, as a long-term investment for China Investment Corporation, the effects in such a short time cannot mean everything. However, if the China Investment Corporation still keeps the way of investment and management unimproved, a large return on investment is difficult to achieve in the future[3].

C. Out dated operating procedure of the foreign exchange reserves management and less flexibility

Look at foreign exchange reserve asset management, although a variety of models in business variety and investment targets has been set up, such as current assets management, invested assets management, currency hedging, and entrusting management, overseas operation management, the main way to operate the foreign exchange reserve is still depositing most of them in foreign banks to get low interests. The foundation of China Investment Corporation really China's poor management of the foreign exchange reserve; however, it is far from enough. Some developed countries like Singapore and Japan, they actively participate in international financial markets with flexible management. Compared with them China's transaction system of investment and management of foreign reserve assets and the participation in international financial markets still lacks of flexibility[4].

From the above, in the asset structure of China's current foreign exchange reserve, China put emphasis on debt investment, ignoring equity investment; put emphasis on treasuries, ignoring financial bonds and enterprise bonds; put emphasis on credit currency investment, ignoring gold investment; and put emphasis on safety and liquidity, ignoring profitability. Which made a big loss in the investment's efficiency. Therefore, it is imperative to improve the profitability of foreign exchange reserve assets.

III. Countermeasures and Suggestions

A. Renew the conception of reserve management, define the targets of reserve assets management more clearly

The overall objective of foreign exchange reserve management is maintaining liquidity, reducing or avoiding the loss of assets, and making profits. While defined the targets of reserve assets management, we should make an analysis on the usage of reserves with the strategic objectives, and classify the reserve assets according to different use and function. Based on different liquidity, profitability, and safety, foreign exchange reserve assets can be classified into three kinds: policy reserves, transaction reserves and profitability reserves. We should make different objectives, choose different management agencies and different investment instruments for different kinds of reserve assets.

For example, we can set up different investment benchmarks for different foreign exchange reserves. The policy reserves and the transaction reserves are used to balance of international trade the trade payment, intervening the foreign exchange market, stabilizing the currency exchange rate and so on. The reserve scale also depends on those needs. Therefore, we can choose low risk investment portfolios, such as short-term bonds with high level of credit, anti-risk financial derivatives or short-term deposits in commercial banks. The profitability reserves are designed to strengthen the nation's reputations in the world. The reserves are not for the current using. The portfolios should focus on generating profit, for instance, the long-term bonds, stocks, domestic enterprises loans and direct investment.

B. Strengthen the functions of the reserve management agency, improve the supervision mechanism of the reserve management

From the international experiences and the domestic practice it is not only necessary, but also feasible to establish specialized agencies to conduct the foreign exchange reserve for market operations. The China Investment Corporation which is founded in September 2007, is a new attempt to manage foreign exchange reserve. To optimize the foreign exchange reserve structure, the China Investment Corporation must run well, and play the role of increasing the value on the foreign exchange reserve. It should improve its management in the following four aspect: strengthen the corporate governance structure, define the corporation's specialization and market positioning, employ the professionals, improve the investment strategies, complete the relevant laws and regulations, and improve transparency of company operations.

C. Increasing flexibility and diversity of asset allocation, adjust the stock of reserves on the own initiative

The type and the proportion of the reserve currency must adhere to the pluralism principle. According to the degree of dependence on foreign trade and economic relevance, we should take the demands for import payment, market intervention, debt repayment and dependence degree of China and foreign country into consideration to arrange foreign exchange reserve. Because

RMB exchange rate system pegs with "basket of currencies" now, foreign exchange reserve assets should increase the proportion of Euro, Yen and other foreign currency assets, reduce dollars reserve accordingly. Considering the correlations between different currencies, Chinese foreign trade dependence and other factors, the decentralization of the reserve currency should be advanced gradually. We should also play close attention to the changes in the currency exchange rates; adjust the proportion of different currencies timely and non-periodic. Besides, the profitability of foreign exchange reserve portfolios should be concentrated. Increasing the investments on long-term bonds, stocks, loans to domestic enterprises, direct investment and so on.

D. Explore and expand the investment channels of reserve assets actively

In recent years, due to the prices of mineral resources, like oil, gold iron ore and others are up, China's foreign exchange reserve assets shrink. At present, China's gold reserves is less than 2% of total foreign exchange reserve. It still maintains the level of December 2002. This is disparity from 60%–70% in the developed country. As oil's price continues to rise, the domestic enterprises' costs increase substantially. China is the only country that has not established strategic oil reserve system among the world's major oil importers. Therefore, direct investment should be expanded, especially on foreign resources of energies, raw materials (such as oil, minerals, natural gas, timber) and other storages. It will not only help the foreign exchange reserve keep, and increase in value, but also help the country to strengthen economic power and maintain a long-term, stable, and sustainable development. At the same time, investment funds of overseas should be settled up. Foreign exchange reserve should combine with state-owned enterprises' strategy of transnational operation and banks' international strategy, introducing Qualified Domestic Institutional Investor (short for QDII), investment overseas sequentially and other practical measures.

E. Asian countries and regional cooperate to establish the Asian Reserve System

Over these years, Asian countries and regional hold the most parts of world's foreign exchange reserve, especially Japan, Mainland China, Taiwan, South Korea, India, Russia, and Hong Kong. The foreign exchange reserve in Asian countries and regions had accounted for 63% of the total amounts by the end of 2006. This reserve distribution pattern not only brought a great risk to Asian economy, but also brought the potential crises to the global economy. Due to the huge U. S. dollar reserves held by Asian countries and geopolitical relations between these countries, it is necessary and urgent to strengthen cooperation of foreign exchange reserve management[5].

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