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\$4 Trillion Peak for China's Stockpile of Foreign Currency May Free PBOC's Hands

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[China](#)'s generation-long accumulation of [foreign-exchange reserves](#) may be at an end, reshaping monetary policy and eroding a source of demand for U.S. Treasuries.

China's stockpile, the world's largest since 2006, will be \$3.5 trillion to \$4 trillion or lower at the end of 2015, according to 12 of 18 economists in a Bloomberg survey. Eleven said the \$3.99 trillion posted on June 30 was the peak.

As it moves towards a more market-driven economy, China has stopped regular foreign-currency purchases and is freeing up restrictions on the flow of money in and out of the country. Fewer foreign-asset purchases lowers the need to print and then lock away the local currency, giving more room to spur an economy that grew last year at the slowest pace since 1990, according to economists' projections.

"For China's central bank, it means the single most important source of liquidity is gone," said Xi Junyang, a finance professor at [Shanghai](#) University of Finance and Economics. "It means the central bank has to find other sources to inject liquidity -- it has to cut the required reserves, it has to create more open-market tools."

China's [reserves](#) as at Dec. 31 were \$3.9 trillion, according to the median economist forecast ahead of data due this week.

In January 1979, when former paramount leader [Deng Xiaoping](#) visited the U.S., China had just \$167 million foreign exchange reserves. By adopting an export-led growth model and a rigid currency policy that encouraged earning foreign cash, reserves expanded to \$140 billion in 1997, the year Deng died.

WTO Entry

The Asia Financial Crisis that began the same year reinforced the push to hoard greenbacks as a buffer to global turmoil. Since China's entry into the [World Trade Organization](#) in 2001, trade

surpluses and capital inflows have seen the PBOC intervene in [currency markets](#) to prevent sharp [yuan](#) gains.

For every dollar bought, the central bank has had to print local currency. To ensure such a liquidity surge didn't spur too much inflation, it made banks set aside more and more money. The biggest banks today must set aside 20 percent of deposits in what is known as the [reserve-requirement ratio](#).

"They used to have to sterilize to offset the effect of purchases on the domestic [money supply](#)," said [Nicholas Lardy](#), author of the book "Markets Over Mao" and a senior fellow at the Peterson Institute for International Economics in [Washington](#). "Now they aren't purchasing much forex so they don't have to do this -- much better environment for monetary policy."

RRR Cuts

The People's Bank of China may lower banks' RRR by a cumulative 100 basis points in the first half, according to economists' forecasts in a Bloomberg survey from Dec. 18-23.

At the same time, Lardy said that China, the largest foreign creditor to the U.S., won't "have too much effect" on the Treasury market as reduced purchases from China and other [emerging markets](#) aren't significant enough to have a major impact on a "very broad" market.

As reserves stop growing, Chinese authorities may attach growing importance to the U.S. Treasuries already owned, said Li Jie, head of the foreign-exchange reserve research office at the Central University of Finance and Economics in Beijing.

"You value your assets when assets aren't growing," said Li. "For the past years, China has been talking about boosting the return of foreign exchange reserves. As the reserve size peaks, however, China is likely to shift focus to liquidity."

China's [State Administration of Foreign Exchange](#) in charge of day-to-day management of the stockpile has never released a breakdown of the reserves.

COFER Report

Globally, the proportion of disclosed allocations invested in U.S. dollar assets increased to 62.3 percent in the third quarter of 2014, according to the International Monetary Fund's report on the currency composition of official foreign exchange reserves, known as [COFER](#).

That was driven by dollar strength rather than increased allocations as "reserve managers were swimming against the stronger USD tide," Kevin Hebner, a foreign-exchange strategist at

JPMorgan Chase & Co. in [New York](#), wrote in a report this month. Beyond 2015, “a glacial decline seems likely” as reserve managers diversify, he said.

PBOC Deputy Governor [Yi Gang](#), who oversees China's hoard, said in November 2013 that it no longer benefits the country to increase the stockpile and that appreciation of the yuan benefits more people in China than it hurts. China may appoint the chairman of the Bank of Shanghai as head of the foreign-exchange regulator after Yi was promoted last year, according to people familiar with the matter.

Premier [Li Keqiang](#) said last month the reserves should support Chinese industries venturing overseas.

Diversification Efforts

Past efforts in diversifying resulted in the bailout of state banks in the early 2000s and the creation of China Investment Corp. in 2007. Now, the cash pile is being used to help fund regional ambitions: Reserves will make up 65 percent of the Silk Road Fund, China Securities Journal reported this month, citing unidentified people.

“Reduced foreign exchange market intervention will create more room for the PBOC to pursue monetary policies that are directed towards domestic objectives such as supporting growth without being concerned about capital flow and currency volatility,” [Eswar Prasad](#), a professor of trade policy at [Cornell University](#) in Ithaca, New York, and senior fellow at the [Brookings Institution](#) in Washington, wrote in an email.

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