An embarrassment of riches, albeit 'unreal'

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At the State Administration of Foreign Exchange, the organisation responsible for managing **China's $2,850bn in foreign exchange reserves**, a multi-coloured globe sits in the middle of a large trading floor.

For those suspicious that China harbours mercantilist, zero-sum designs on global resources, it is an ornament worthy of a Bond villain's lair. In the US, in particular, officials from across the political spectrum have expressed concern that – in any future confrontation – Beijing could leverage its position as the single largest foreign owner of US Treasury securities.

In a March 2009 conversation with Kevin Rudd, Australia's then prime minister, Hillary Clinton, the US secretary of state, hinted at that anxiety.

"How do you deal toughly with your banker?" she asked in a conversation about China, according to a diplomatic cable revealed by WikiLeaks, the whistleblower website.

But while some Chinese leaders do see the **pile of reserves** as a source of strength and pride, for others it is a double-edged sword.

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"China's foreign exchange reserves cannot be regarded as a tool of financial power," Xiao Gang, chairman of state-owned Bank of China, argued in a recent essay. "The reserves are actually a manifestation of the country's balance sheet and not real wealth."

Mr Xiao was alluding to a process that, according to detractors, is simply a variant of the US Federal Reserve's policy of **quantitative easing**. Under QE the **Fed prints money to buy government bonds** in an effort to push down long-term interest rates and stimulate the economy.

In China, the central bank prints money to buy the foreign exchange earnings generated by the country's exporters. While the motive is different – to peg the renminbi to the dollar at what many believe is an undervalued rate – the result is the same.

As Mr Xiao puts it, the policy comes "at the cost of pouring huge amounts of base money into the domestic market". Unlike the Fed, however, the People's Bank of China must try to limit the inflationary impact. It issues bonds in an effort to mop-up, or "sterilise", the liquidity. Beijing has also introduced a series of policies aimed at reducing future inflows into the reserves. Exporters, for example, have been allowed to keep more foreign exchange earnings overseas.

And measures aimed at promoting **internationalisation of the renminbi** – by allowing the currency to be used for international settlement or, more recently, for overseas investments and acquisitions – are also intended to slow the growth of the reserves. But restricting capital inflows remains an enormous challenge. China's forex reserves grew by about $450bn last year. After reaching the trillion-dollar mark in late 2006, it took just another two and a half years for the reserves to swell to two trillion.

"A country needs foreign exchange reserves to pay for its imports or to guarantee it can pay its external debt, but China long ago reached the point where it had sufficient reserves," says Michael Pettis, a professor of finance at Peking University. "Beyond that the value of reserves is quite limited and the costs rise as the reserves do."

Destinations for liquidity

China struggles to find reliable, liquid investment opportunities for its embarrassment of riches. Reluctantly, it has had to rely on the US Treasury market as a safe haven, thus subsidising America's cost of capital and fuelling the global imbalances and asset inflation that helped precipitate the global financial crisis.

"Despite China's desire to break out of reliance on US Treasuries, in particular, there just isn't another market that can absorb the level of inflows currently going into the Chinese reserves," says Eswar Prasad, a trade policy professor at Cornell University and former head of the International Monetary Fund's China division. "[The reserves] are a serious political problem for the Chinese leadership both internationally, where they are seen as evidence China is manipulating its currency, and domestically, where they are seen as the nation's wealth and so any capital loss on the portfolio is politically unacceptable."

CIC's struggle to loosen control

Beijing set up China Investment Corp, its first sovereign wealth fund, in 2007 to diversify its reserves away from low-yielding sovereign bonds.

Some Chinese leaders nevertheless promote the idea that Beijing can use its reserves for political gain. They have publicly promised to buy unspecified amounts of sovereign debt from countries in the eurozone crisis. Although Chinese officials have never explicitly presented these debt purchases as conditional, they have hinted that Europe should in return lift its arms embargo (imposed after the 1989 Tiananmen Square massacre) and recognise China as a market economy, which would strengthen its position in disputes moderated by the World Trade Organisation.

But with only about a quarter of China's foreign exchange reserves invested in euro-denominated assets – and given Beijing's desire to reduce its reliance on dollar assets – European officials say privately that China is not in a position to cajole the EU.

"Beijing is clearly trying to make virtue out of necessity – the necessity being the fact they have no choice but to keep investing their reserves into big liquid developed markets," says Mr Prasad. "Rather than admitting they have no choice, they're trying to make it seem as if they can leverage reserves for political gain ... In the end it's not a very credible strategy."

Wang Jianxi, CIC executive vice-president, said last weekend that the **fund, which was capitalised with $200bn of reserves, has invested more than $300bn and is looking for an infusion from the government**.

Gao Xiqing, CIC president, said the fund had yet to break free from the bureaucratic mould of the State Administration for Foreign Exchange.

"We were destined to become constrained by government interference," Mr Gao said last month. "We have antagonised a lot of government agencies."

CIC has leant towards public securities. In 2007, it invested $3bn in Blackstone, the private equity firm, and took a 9.9 per cent stake in Morgan Stanley. In 2008 it mandated JC Flowers to invest in distressed financial institutions. As the paper value of the investments dwindled in the financial crisis, CIC became an easy target for domestic critics.