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China's large forex reserves constitute both a blessing and a curse

By Gabriel Wildau Author alerts

Chinese foreign-exchange reserves are viewed as a sign of national strength and a buffer against global financial turmoil, but as the forex pile grows ever larger, it is becoming an albatross around the neck of the financial authorities.

As the country began running large trade surpluses, forex reserves grew from \$610bn at the end of 2006 to \$4tn by June 2014. It came through the 1998 Asian financial crisis largely unscathed, but policy makers observed the capital flight and exchange-rate devaluation that afflicted such neighbours as Korea and Indonesia.

They resolved that large forex reserves, along with controls on cross-border capital flows, were essential to avoid a similar fate.

But managing China's reserves has become more difficult. Their composition is officially a state secret, but outside analysts broadly agree that about two-thirds are held in US dollars, a quarter in euros, and the rest in Japanese yen and British pounds.

That means the renminbi-denominated value of the reserves is vulnerable to a depreciation in the greenback.

Much like its counterparts in other countries, China's State Administration of Foreign Exchange (Safe) defines the goals of its reserves management policy as safety, liquidity and yield. Yet achieving the first two goals comes largely at the expense of the third.



Eswar Prasad says reserve managers are worried about taking on too much volatility as they are evaluated on both long- and short-term returns

In terms of assets, nearly all of China's official reserves are held in government and agency debt, as well as money-market assets, analysts believe. This conservative portfolio has kept returns low. It also exposes the portfolio to mark-to-market losses if dollar interest-rates rise, a likely outcome as the Federal Reserve ends quantitative easing. Apart from the US Treasury market, few financial markets are deep enough to absorb large inflows without driving up prices. Stock markets in the US and Europe would be one exception, but Chinese reserve managers have so far been unwilling to accept the added risk.

That is due in large part to the political pressure on China's reserve managers, who would come in for criticism if they were seen taking losses on their reserves.

In 2007, China launched a sovereign wealth fund, the China Investment Corporation that operates independently from Safe, to raise returns on a portion of the reserves. But poor results from CIC's initial investments led to a backlash that still weighs on both CIC and Safe.

Eswar Prasad, a renminbi expert at Cornell University, says: "The problem is that they are evaluated not only on long-term returns but short-term as well, so they are concerned about taking on too much volatility."

That means Safe is likely to continue ploughing money into US and euro debt, while CIC cautiously invests in equities, commodities and property.

Domestic financial reform: Finally, a bite of the apple

The coming wave of financial deregulation in China promises foreign asset managers unprecedented access to capital markets, but the reforms may do little to improve the fortunes of western financial institutions inside the country.

Deregulation is at the core of a landmark reform blueprint approved by China's Communist Party leaders last year, granting market forces a "decisive" role in resource allocation. That means unlocking domestic interest rates and loosening capital controls.



The moves will offer foreign portfolio investors new channels into the country's stock and bond markets and could pave the way for China's domestic A-share market to be included in the MSCI Emerging Markets Index. MSCI rejected that change last year because of restrictions on investability but will reassess its decision next year.

A new opening would be welcome news to foreigners, given the limitations of the Qualified Foreign Institutional Investor (QFII) programme, the main channel through which foreign asset managers currently access China's onshore capital markets.

Launched in 2002, QFII requires lengthy approvals from two agencies. Once funds are invested in the Chinese market, repatriating them is difficult. The Renminbi QFII programme, which allows fund managers to invest onshore renminbi funds raised offshore, is only slightly more flexible. The foreign-exchange regulator has so far granted only Rmb645bn (\$105bn) in combined quotas under the two programmes – a tiny fraction of Rmb33tn in domestic bonds outstanding and the combined market capitalisation of Rmb27tn for the Shanghai and Shenzhen stock exchanges. Regulators have said a programme to allow mainland and Hong Kong investors access to one another's stock exchanges will be launched in October. Though subject to quotas and limited to large-cap shares, the programme will not require each investor to seek separate approvals.

Prospects for foreign banks, brokerages and fund houses operating in China are bleaker. Foreign banks have struggled to gain approval to open branches or fund themselves through their foreign parents. They control a meagre 1.7 per cent of bank assets. In securities and fund management, foreign investors must operate through joint ventures in which their stake is capped at 49 per cent. And many Sino-foreign securities joint ventures have been unable to win secondary-market trading licences.

"The framework has been set, if not against [foreigners], then with very little concern about whether or not they're involved," says Fraser Howie, director at Newedge Singapore and co-author of *Red Capitalism: The Fragile Financial Foundation of China's Extraordinary Rise*.

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