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Risks for and Precautions of China's Foreign Exchange Reserves

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In view of China's disadvantages in the fields of science and technology and finance, the Chinese government should take a long-term view and restrain from overreaction, so as to create a long-term stable and relaxed international environment for China's development. In the short term, China's foreign exchange reserves management should maintain a low-key profile in its investment behaviors. China should not significantly reduce the amount of U.S. treasury bonds held to avoid becoming a target of international market attention. In the medium term, China should reassess the investment returns and risks of the U.S. market, and resolutely promote the diversification of foreign exchange reserve assets, as well as to optimize the currency structure and regional distribution of reserve assets based on the situation of Chinese economy.

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The size and structure of the U.S. security assets held by China

The types of U.S. security assets held by China mainly include government bonds, agency bonds, stocks and corporate bonds, all featuring high credit rating and long terms. According to the figures released by the U.S. Department of the Treasury, at the end of February 2018, China held USD1.1766 trillion of U.S. treasury bonds, accounting for 37.5% of China's foreign exchange reserves, which included USD1.1726 trillion of long-term government bonds, accounting for 99.7% of the total, and USD40 billion of short-term treasury bonds, accounting for only 0.3%. In January 2018, the U.S. security assets held by China amounted to USD1.5802 trillion, accounting for 50% of China's foreign exchange reserves, which mainly included USD1.1645 trillion of long-term government bonds that accounted for 73.7% of the total, USD166.2 billion of long-term agency bonds that accounted for 10.5%, USD229.7 billion of stocks that accounted for 14.5%, and USD16.1 billion of corporate bonds that accounted for 1.0%. Obviously, this term structure makes China's foreign exchange reserves vulnerable to interest rate risks and inflation risks. In addition, China may have also invested in the U.S. security market through some international financial centers in Europe, such as London and Luxembourg, so that the actual investment scale of China in the US should be slightly higher than the figure released by the U.S. Department of the Treasury.

It is worth noting that from November 2016 to January

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2018, China has been steadily increasing its holdings of U.S. dollar security assets. Its holdings of U.S. securities and government bonds have increased by USD139.8 billion and USD118.8 billion, respectively, with their shares in foreign exchange reserves rising by 2.78% and 2.56%, respectively. At present, China remains the largest overseas investor of U.S. treasury bonds, holding 18.7% of total U.S. treasury bonds held by all the foreign investors, and accounting for 9.68% of the U.S. government's public debts.

Risks for China's foreign exchange reserves

With a significant deterioration in the U.S. investment environment, the risk of regulatory policy uncertainty has risen for Chinese capital. Under the current situation, we cannot rule out the possibility that China's foreign exchange reserves may become the target of U.S. trade retaliation and the Chinese government should be highly vigilant about this. Meanwhile, the Fed's interest rate hikes and the rise in U.S. government debts have led to an increase in interest rate risk, inflation risk and exchange rate risk of the investment of China's foreign exchange reserves in U.S. dollar assets.

At present, the biggest risk facing China's foreign exchange reserves for holding U.S. treasury bonds is political risk, that is, the risk of being frozen by the U.S. government. According to the officials of the U.S. Department of the Treasury, the U.S. government is assessing the possibility of launching the International Emergency State Economic Power Act on Chinese investment, and has set up a special office for this purpose. According to the Act, the President of

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the US has the right to declare a national emergency status in response to unusual and extremely serious threats. In this case, the U.S. government has the right to block international transactions or seize assets, and even freeze financial assets such as U.S. treasury bonds held by China. If the U.S. government implements the Act against China, the huge amount of U.S. treasury bonds held by China will face great uncertain risks.

The Fed's interest rate hikes and exiting strategy from quantitative easing, the U.S. government's tax cuts and rising public debts, and the increase in the U.S. inflation rate have posed a challenge for the preservation and appreciation of U.S. long-term treasury bonds held by China, resulting in an increasingly prominent mismatch between the income and risks of China's foreign exchange reserves. At present, China's foreign exchange reserves are facing three potential risks of capital loss. The first is the risk of implicit credit default. The sharp tax cuts by the Trump administration is bound to lead to a rapid rise in U.S. public debts. Although the U.S. government does not have explicit debt behavior, it has a strong incentive to reduce the actual value of debt by increasing inflation. The second is the interest rate risk. The Fed's policies of exiting from quantitative easing and raising interest rate will lead to an increase in the yield of U.S. treasury bonds and a fall in bond market prices. The third is the inflation risk. The U.S. inflation rate has risen markedly, and the U.S. government's expansionary fiscal policy will continue to boost market prices, which will lead to a decline in the actual purchasing power of dollar assets.

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Risk precautions

First, China should make appropriate concessions to avoid an excessive deterioration and escalation of trade friction. Although this trade friction is highly related with Trump's right-wing populism, the main reason is that China has a long-term large trade surplus with the US. As the second largest economy in the world, China cannot continue to rely on external demand to promote economic growth. It must take this opportunity to make a comprehensive adjustment to the export-oriented growth model. China should prevent trade friction from expanding to investment and financial sectors and having a direct negative impact on the security of foreign exchange reserve assets. Creating a stable and relaxed international environment for China's peaceful rise is the primary goal of China's diplomacy that serves China's fundamental interests, and other goals must be subordinated to and serve this goal.

Second, foreign exchange reserves should not be used as a tool for China's trade retaliation against the US. At the present stage, China should maintain a basically stable investment in U.S. treasury bonds rather than substantially reducing its holdings. Some scholars have argued that China should sell off U.S. treasury bonds as a punishment for the US. This view is clearly irrational for the following reasons. Firstly, the U.S. treasury bond market is the world's most liquid and largest bond market, and China's sell-off will only have a small impact on U.S. treasury prices. Secondly, U.S. treasury bonds are safe-haven assets. Although the market panic triggered by China's massive selling may cause a large

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amount of funds to flow to the treasury bond market, it is likely to result in a fall of the prices of private security assets, but a rise of the prices of treasury bonds in the US. Thirdly, if the Federal Reserve enters the market, it may offset the impact of China's selling on U.S. financial markets. Fourthly, even if the sell-off can successfully suppress the price of U.S. treasury bonds, China will also suffer large asset losses, and it will be difficult to find suitable investment channels for these huge assets in the short term. Fifthly, it will provide the U.S. financial regulatory authorities with an excuse to investigate and sanction China's investment in U.S. treasury bonds on the ground that the economic security of the US is threatened, which will jeopardize the U.S. dollar assets invested by China. In this sensitive period, China may reduce its holdings of U.S. treasury bonds but in a controllable scale and pace to avoid becoming a target of international market attention.

Third, from a medium-term perspective, China should comprehensively assess the investment returns and risks of the U.S. market, firmly accelerate the diversification of foreign exchange reserves, and optimize the currency and asset structure of foreign exchange reserves. China should re-adjust its ideas and direction of foreign exchange reserve investment and learn from the experience of sovereign wealth funds in Norway, Singapore and other countries. The objective of foreign exchange reserves management is not only to maintain the stability of local currency, but also to disperse the economic risks of the country. For example, the Norway's sovereign wealth fund has chosen the global non-oil

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and gas industry as its investment target for the main purpose of reducing the country's highly economic dependence on the oil and gas industry. In terms of asset selection, China's foreign exchange reserves should increase financial investment in resources, energy and technology to alleviate the negative impact of bulk commodity price fluctuations on China's economy and share the economic dividends of global technological progress and innovation. In terms of regional distribution, China's foreign exchange reserves should adjust the imbalanced regional investment structure, reduce investment in the US, and increase investment in Europe. In the future, when China's ability to invest abroad further enhances, China should significantly increase its investment in emerging economies and developing countries.

Finally, the scale of China's foreign exchange reserves is likely to decline. We must be alert to the risk of foreign loans repayment, and maintain a stable scale of foreign exchange reserve entrusted loans. During the current Belt and Road construction, China's foreign exchange reserves have provided a strong financial support through capital injection in financial institutions such as policy banks, Asian Infrastructure Development Bank and Silk Road Fund, as well as issuance of entrusted loans. Considering that the source of foreign exchange reserves may be reduced and the risk of countries along the Belt and Road is relatively high, China's credit support for the Belt and Road infrastructure projects should remain generally stable rather than growing too fast, so as not to negatively affect the asset quality of foreign exchange reserves.

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