Summary for non-specialists
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Management of China's Foreign Exchange Reserves: A Case Study on the State Administration of Foreign Exchange (SAFE)

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One major development in the global financial system over the past decade has been the rapid growth of foreign exchange (FX) reserves around the world. Data shows that the size of global FX reserves increased from USD 1.4 trillion (tr.) in 1995 to USD 1.9 tr. in 2000, and further to USD 7.5 tr. in 2009. Against this background Chinese FX reserves have also increased rapidly over the past. In 1993 the size of Chinese FX reserves was only about USD 20.1bn, but this figure increased gradually to USD 165.6 bn in 2000, and further to USD 2.4tr in 2009, accounting for 31.9% of global FX reserves in 2009 in comparison to 5.3% in 1995.

Given the rapid accumulation of Chinese FX reserves over past 20 years and the trend of continuing growth in the foreseeable future, the question of how to manage those reserves has become a big challenge and somehow a burden for the Chinese authorities. In this paper we focus on the central questions, i.e. how Chinese FX reserves are currently managed and the possible solutions available.

To achieve this objective we first conduct a detailed overview of the State Administration of Foreign Exchange (SAFE), i.e. the Chinese governmental agency in charge of administering China's FX reserves. Despite great and growing interest in SAFE, this institution has so far remained as one of the most secretive reserve managers in the world. Meanwhile we review investment strategy of SAFE, and our analysis shows that SAFE investment has been traditionally conservative (with a large proportion invested in the US government bond). However interesting trend has been observed for SAFE recently, e.g. reduced investment in the US treasury bonds and higher allocation to equities. These observations have important policy implications.

SAFE has been recently receiving increasing attention both within China and abroad. The reasons arise from both domestic and abroad factors.

Domestically, several economic issues are closely linked to huge accumulation of FX reserves in China, e.g. inflationary pressure and opportunity cost. Meanwhile, low return associated with SAFE investment has aroused strong criticism in China regarding SAFE's ability in managing China's FX reserves, particularly in view of better performance of its Chinese rivalry, i.e. China Investment Company (CIC).

Globally, a high concentration of SAFE's portfolio in U.S. government bonds raises concerns in the U.S., on the grounds that the Chinese government might be able to use the position of a large creditor as leverage against the national interests of the latter, although we believe that this argument holds in theory, while in practice it is not achievable or at least not desirable for both the Chinese and U.S. governments. Meanwhile, SAFE is diversifying their investment by type of assets, and probably by geography as well. Given the size of its overall holdings, foreign observers have shown their concerns about such movements, given its potential impact on global financial markets. Perhaps what foreign observes are more concerned is transparency of SAFE's governance and therefore the possibility of political decisions behind SAFE's investment.

In the paper the following policy recommendations are proposed from various angles and aim at suggesting solutions which could benefit both China and the outside world:

First of all, the economic growth model in China needs to be changed, which has directly contributed to the rapid growth of FX. Therefore the government needs to stimulate its domestic consumption - through an improved social security system, and reduce over-reliance on investment and export. It would also be helpful in terms of reducing global imbalances.

Second, greater exchange rate flexibility might be allowed, which would enable reducing FX reserves, and more importantly help upgrade the Chinese export industry from the low-cost end of the global chain to the upper end featuring high quality and its own brand. Nevertheless, we admit that this process would be gradual and cautious.

Third, given a continued, steady surplus in the capital account, the government might consider liberalizing its capital account. In view of the current situation, capital outflows could be liberalized further, so allowing not only SOEs, but private firms and individual investors to invest abroad. This would greatly diversify the risk concentrated on one institution (i.e. SAFE), or this small number of selected institutions.

Fourth, SAFE investment needs to be diversified further. It could be achieved by currency, type of asset and geography. Geographical diversification, for example, could potentially help those countries in need of capital to develop local economy and further raise peoples' living standards.

Last, but not least, SAFE may establish a separate SWF under its authority, but at arm's length, while all excess reserve funds could be transferred to this institution. Several major advantages are associated with this change. Most importantly it provides the opportunity for greater transparency, therefore alleviating concerns raised by foreign observers. Although it may create a domestic rivalry for CIC, it is believed that such competition already exists, and from the government perspective, such competition might be positive; such positive benefits are particularly the case if certain a mechanism is pre-arranged and establishes a complementary competition platform between the three major institutions managing the Chinese FX reserves, i.e. SAFE, CIC and CIC 2.