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China’s foreign exchange reserves – a currency policy with risks and side-effects

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Foreign exchange reserves have increased due to targeted interventions

An important feature of China’s economic boom is the dramatic increase in the country’s foreign exchange reserves – from USD 600 billion in 2005 to nearly 4,000 billion by mid-2014 (see Figure). This has come about as a result of targeted interventions by the central bank, which buys foreign exchange earned by Chinese exporters, but does not make all of it available to Chinese importers. It keeps part of it back and in that way accumulates foreign currency reserves.

The formation of foreign exchange reserves is part of a central bank’s normal activities. However, the reasons for intervention, and hence the size of the reserves, vary from one country to another. Nobody can argue with the prudential motive: foreign exchange reserves ensure that an economy is able to meet its payment obligations at all times. But in China’s case, according to the IMF, such uncontroversial considerations account for only about half of the reserves the country has built up. The Chinese central bank has intervened heavily in foreign exchange markets to prevent an appreciation of the renminbi (RMB) which would otherwise result from China’s large current account surplus. The RMB’s undervaluation has clearly benefited China’s exports.

China has met with international criticism for its currency policy

In 2010, the RMB’s undervaluation relative to the US dollar was estimated at 30 %. At times, critics have described it as a currency war and held China largely responsible for the global external imbalances seen as one of the causes of the global financial crisis.

But there are risks for China too

China’s exchange rate controls have led to a misallocation of resources: areas of production have emerged that would otherwise be uncompetitive (export-oriented businesses and those that make substitutes for "superior" imports).

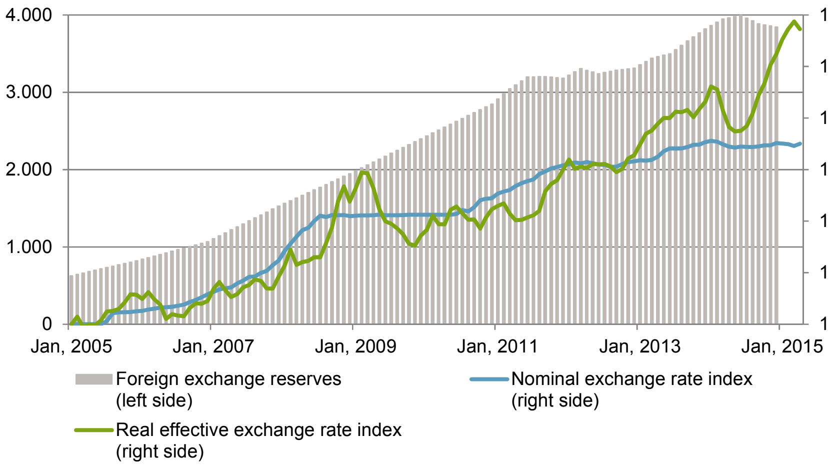
Also, China’s foreign exchange reserves do not lie idle but are invested abroad with the aim of generating a return. The precise allocation is unknown (being a state secret) but the USA is probably a favoured investment target. China may well have sustained losses in America on its investments in private companies, real estate and above all the financial sector.

Other significant credit risks relate to China’s efforts to gain market access to raw materials in developing and emerging countries and to upgrade infrastructure there. These include countries with bad credit ratings and limited access to capital markets, such as Venezuela, Argentina, Zimbabwe or Pakistan.

Recent signs of normalisation

The figure shows that China’s foreign exchange reserves are no longer growing but stagnating at a high level or even falling slightly. The RMB has appreciated significantly, both in nominal terms and especially in real effective terms (taking inflation differentials and trade flows into account). The IMF no longer considers the RMB to be undervalued. The previously high current account surplus has declined to a moderate 2 % of GDP (2014). The recent exchange rate policy reflects the altered Chinese growth model, which aims to shift the focus away from the growth drivers of exports and investments and towards domestic consumption. ■

Figure: Foreign exchange reserves (in USD billions) and exchange rate (nominal vs. USD and in real effective terms, index: January 2005=100)



Source: CEIC, BIS, own calculations