

Questions grow over China's forex strategy

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China's foreign exchange regulator raised more questions than it answered with a statement on Thursday evening about a possible change in its strategy for managing the country's burgeoning foreign currency reserves.

Buried in an announcement about the agency's objectives for 2006, the State Administration for Foreign Exchange (Safe) said it wanted to "optimise the currency and asset structure" of the country's foreign exchange reserves and to "actively boost investment returns".

Although the statement contained no concrete information, it set off alarm bells for some economists, given China's prominent role in the market for US government securities. The spectre of Asia's central banks deciding to diversify away from their dollar holdings has long threatened a sharp drop in the value of the US currency.

Stephen Green, economist at Standard Chartered in Shanghai, estimates that China is responsible for about 15 per cent of foreign purchases of dollar assets. As a result, comments about a shift in investment strategy were likely to put further downward pressure on the US currency, he said.

However, there is still considerable uncertainty about both the nature of China's plans for its \$800bn (EU660bn, £456bn) of reserves and the potential impact of any shift in strategy on global financial markets. Economists estimate that as much as 75 per cent of China's reserves are held in dollar assets.

With China soon set to surpass Japan as the largest holder of dollar reserves, that may increase political sensitivities in Washington about Beijing's currency intervention and the size of the US trade deficit with China.

China broke its currency peg to the dollar last July and moved to a link to a basket of currencies. A shift in its reserve accumulation policy away from US assets might be part of a policy to allow the renminbi to rise gradually against the dollar.

But market reaction yesterday to the announcement was limited. China-watchers pointed out that the statement on Thursday evening did not come out of the blue, but followed comments by government officials and academics questioning the wisdom of China's reserves management strategy.

Last month Yu Yongding, a prominent academic who sits on the central bank's monetary policy committee, warned that China's reserves could be seriously eroded if the US dollar weakened further, a comment interpreted in some circles as a warning against excessive investment in dollar assets. However, Thursday's statement did break new ground: it was a public statement by Safe, rather than comments by individuals.

Gene Frieda, head of emerging markets strategy at Royal Bank of Scotland, said he did not expect the dollar to be significantly affected. "China is important to the US bond market, but if there is any move to diversify, it will be at the margins," he said.

It is likely any new strategy would only involve the investment of new reserves - which are accumulating at a rate of \$15bn a month - rather than sales of existing assets.

An effort by the Chinese government to higher returns on the country's reserves would not necessarily lead China to diversify from US assets. Purchasing US corporate bonds would be one way to increase the yield. CNOOC's ill-fated bid for Unocal, the US oil company last year, which was dropped in the face of US political opposition, suggests it is unlikely that China will seek more investments in US energy companies.

Foreign investors have continued to be willing to finance the US current account deficit at very low interest rates in spite of the foreign exchange losses they suffered during the dollar's decline from 2002-04. This has made it easy for the US to finance its current account deficit, which has risen above 6 per cent of gross domestic product and requires the US to import more than \$2bn of capital from abroad every day.

But it would not need China to start dumping dollar assets for there to be pressure on the dollar. If China became less willing to continue adding to its holdings of US Treasuries, that itself could put downward pressure on the dollar and upward pressure on US interest rates - particularly if it encouraged other countries to follow suit.

Oil-exporting countries have become increasingly important sources of foreign capital, owing to the high oil price, becoming as important as developing Asian countries in financing the US deficit.

Encouragingly, for dollar bulls, the US Treasury's data also suggest foreign direct investment started to rise last year and a pick-up in private portfolio flows to the US meant it relied less on purchases of Treasury bonds by foreign central banks.

But the size of the US current account deficit, the prospect that the end of the Federal Reserve's campaign of interest rate increases is in sight, and the possibility of a slowdown in the US economy may lead to renewed pressure on the dollar, some economists forecast.

In such an event, the International Monetary Fund and the World Bank have warned that developing countries face potentially large losses on their holdings of dollar reserves. Diversification makes sense for individual countries, including China, but may cause trouble if a number of countries try to do it at once.

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