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ECIPE PRESS RELEASE — NEW POLICY BRIEF

Turning China's Money Reserves into Capital

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Brussels, Belgium, 4 May 2015 - Some economies in East Asia have built up large amounts of foreign exchange reserves in the past decades. Holding large amounts of reserves helped these economies to stabilize their macro economy and exchange rates under periods of market stress and rapid shifts in relative economic size. Generally, it has been a strategy to provide a defence against external shocks with damaging consequences for exports.

Rules aimed at limiting foreign reserves, in order to prevent currency manipulation, have been discussed over a long period of time. Yet there are to date no rules that come with effective disciplines – and it is unlikely that such rules can be agreed multilaterally, at least for the foreseeable future.

What measures has China adopted to cope with these challenges?

The first line of defense was assigned to the State Administration of Foreign Exchange (SAFE), part of the People Bank of China (PBOC), with the objective to diversify away from U.S. government securities. In essence, the purchasing of new U.S. Treasury bonds was going to decelerate, if not stop. This is not an adequate policy. Even if China would reduce its U.S. denominated foreign exchange reserves, it does not answer the question what China should do with all the assets it has already accumulated.

Improving the safety of its foreign reserves and the yields it can realistically expect is linked to improving China's institutional structure for financial competition and openness. In order to transition some of its current reserves, China should "decentralize" and move capital into the economy guided by solid market mechanisms. Financial liberalisation would allow the country to consider redeployments of its foreign reserves – redeployments allowing for greater amounts of investment from China in America's real economy.

Even if China's foreign reserves seem destined to shrink, redeployment is necessary if China wants to gain better control over its reserves by reducing its exposure to larger systemic and macro risks. This Policy Brief offers a discussion around various alternatives for China's government to achieve that aim – and especially takes stock of an idea to shift reserves into equity.

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