

# Paths to Manage the Huge Chinese Foreign Exchange Reserves

Jingwen Zhang

Shanghai University, No. 20th Jiading Road, Shanghai, China

627710420@qq.com

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**Abstract:** Foreign exchange reserves are vital to a country and an economic entity, especially for a rapidly growing emerging economic entity like China. To make it better to play the role of regulating the economy, it needs to be maintained at a moderate level. Chinese \$3 trillion in foreign exchange reserves virtually increased the cost of holding huge foreign exchange reserves, but also increased the risk of holding huge foreign exchange reserves and the difficulty of managing huge foreign exchange reserves.

## 1. Introduction

In recent years, the explosive growth of China's foreign exchange reserves has aroused the concern of our people, so it is of great significance to find out the shortcomings in the management of China's foreign exchange reserves and the risks that may be faced, as well as to put forward measures to improve the profitability and liquidity of foreign exchange.

## 2. Status Quo of China's Huge Foreign Exchange Reserves

Since the late 20th century, China's foreign exchange reserves have been growing, and there has been a slight decrease in the past two years. According to the International Foreign exchange Reserve Authority, as of 2018 September, China's foreign exchange reserves were \$3.087 trillion, down 0.73% from 2018 August, but still ranked first in the world. At the same time, as of 2015 December, China's official foreign exchange reserves were \$ more than 3 trillion trillion, 4 times times higher than in 2005, when China held even more foreign exchange reserves than the OECD countries combined. As can be seen from table 1, after entering the 21st century, China's foreign exchange reserves opened a period of explosive growth[5].

Table 1 Size of China's foreign exchange reserves in 1950-2016 [billions of US dollars]

Year	Size	Year	Size	Year	Size	Year	Size	Year	Size
1950	1.57	1964	1.66	1978	1.67	1992	194.43	2006	10663.44
1951	0.45	1965	1.05	1979	8.4	1993	211.99	2007	15282.49
1952	1.08	1966	2.11	1980	-12.96	1994	516.2	2008	19460.3
1953	0.9	1967	2.15	1981	27.08	1995	735.97	2009	23991.52
1954	0.88	1968	2.46	1982	69.86	1996	1050.49	2010	28473.38
1955	1.8	1969	4.83	1983	89.01	1997	1398.9	2011	31811.43
1956	1.17	1970	0.88	1984	82.2	1998	1449.59	2012	33115.9
1957	1.23	1971	0.37	1985	26.44	1999	1546.75	2013	38213.2
1958	0.7	1972	2.36	1986	20.72	2000	1655.74	2014	38430.2
1959	1.05	1973	-0.81	1987	29.23	2001	2121.65	2015	33303.62
1960	0.46	1974	0	1988	33.72	2002	2864.07	2016	30105.17
1961	0.89	1975	1.83	1989	55.5	2003	4023.51	2017	31399.49
1962	0.81	1976	5.81	1990	110.93	2004	6099.32		
1963	1.19	1977	9.52	1991	217.12	2005	8188.72		

With the deepening of China's open degree and the rapid development of import and export trade,

under the background of trade surplus, China's foreign exchange reserves have experienced a gradual accumulation of accumulated process. As shown in the figure below, China's foreign exchange reserves reached 38430.18 U.S. dollars at the end of 2014, and in the past two years, China's foreign exchange reserves have declined. Figure 1.

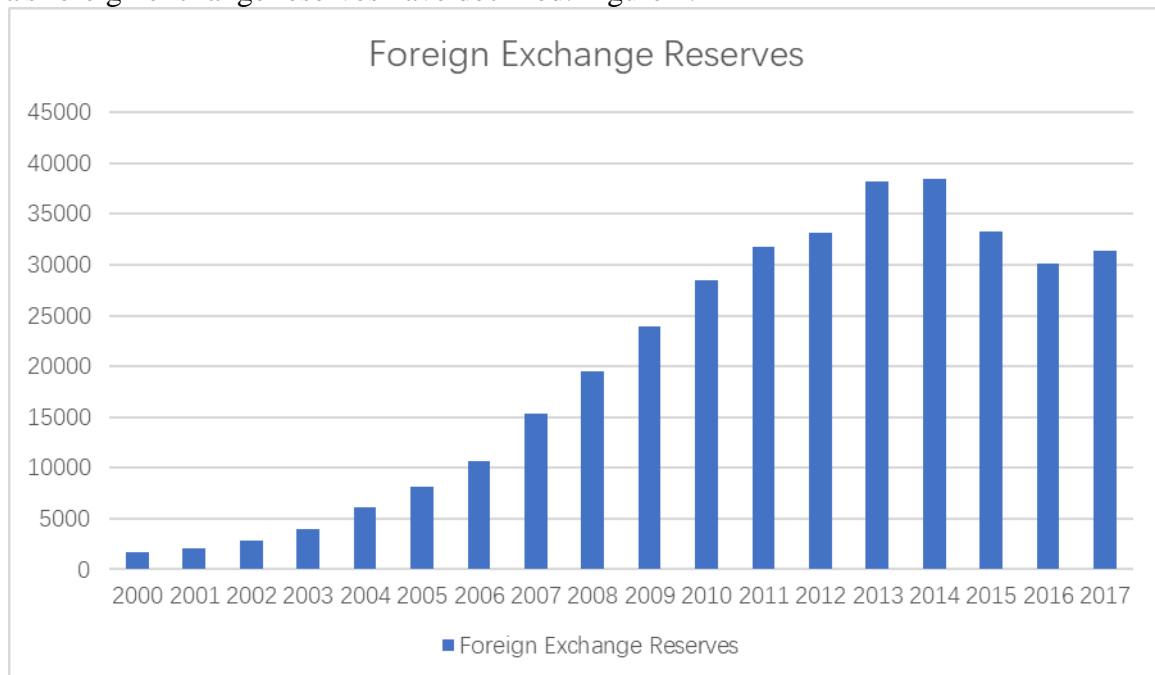


Figure. 1 China's 2000-2017 foreign exchange reserve size

### 3. Factors influencing China's Foreign Exchange Reserves

#### 3.1 The Existing Mode of Economic Growth in China[1].

China's trade development has been a surplus, seriously hindering China's economic equilibrium, because China's economic growth is generally composed of high savings rate, high investment rate, low consumption rate composition, in the past 20 years, under this development model, the average annual growth rate of China's economy has exceeded 9%. The rising level of China's economic development has led to a sharp rise in the level of foreign exchange reserves.

#### 3.2 China's Existing Foreign Exchange Management System.

In 1994, China began to implement a floating exchange rate system, under the condition of establishing a unified national trading market based on market supply and demand, to prohibit the circulation of foreign currency in China, and to use the method of law to reasonably regulate the balance of payments and other aspects. This system stipulates that the foreign exchange of the enterprise must be sold to the bank, the enterprise can not hold, so that China's foreign exchange market has a large supply accumulation, did not get a good circulation. China's foreign exchange reserves as a result of this mandatory system has always been in a passive position, a large number of foreign exchange reserves quickly gathered together to form a magnified number.

#### 3.3 China's Existing Economic Views[2].

In the culture that China has inherited for many years, frugality has been regarded as a good tradition, coupled with inadequate systems, which have made Chinese residents more willing to put their savings in banks.

#### 3.4 Current International Environment.

Decades of rapid growth have made the international community generally optimistic about the prospects for global economic growth, international hot money and the increasing emphasis on China's foreign direct investment influx, forming a clear capital and financial project surplus in

China, and the increasingly close development of economic globalization and the global industry associated with the transfer, which has accelerated the growth of China's foreign exchange reserves[4]. As a result of the development of globalization and the transfer of global industries, China's export volume continues to rise, resulting in the massive transfer and flow of international capital to China, leading to the rapid growth of China's foreign exchange reserves.

#### **4. Risks of China's Huge Foreign Exchange Reserves**

##### **4.1 Exchange Rate Risk.**

The first risk posed by huge foreign exchange reserves is exchange rate risk. In recent years, the Central People's Bank has continuously invested a large amount of base currency in the foreign exchange market, and by purchasing foreign exchange assets to maintain the stability of the value of the renminbi, because China's foreign exchange, the United States dollar accounted for nearly 70%, if the dollar is lower in succession, the risk of serious devaluation of China's foreign exchange assets.

##### **4.2 The Risk of Shrinking US Debt Assets[3].**

As of January 2018, China holds \$1.1682 trillion trillion in US debt, the second-ranked Japan holds \$1.0658 trillion trillion in US Treasuries, and changes in US debt assets are crucial to China's foreign exchange reserves. China's huge foreign exchange makes China more sensitive to changes in the world economy, and any changes that occur in the world economy are likely to have a big impact on China, and will be subject to some constraints and threats by other countries and become more passive in economic development.

##### **4.3 For the Purchase of Foreign Treasuries.**

Chinese investors bought about \$9.98 trillion in Japanese debt in 2016, the largest holder of Japanese debt in the market today.

##### **4.4 Shareholding System used to Reform Domestic Financial Institutions.**

Draw on the experience of South Korea, India, Singapore and other countries in dealing with foreign exchange reserves. The State Council of China, as a pilot, implemented a joint-stock transformation of the two banks in 2014, and the Ministry of Finance invested 22.5 billion of dollars in China's foreign exchange reserves to replenish its capital and enhance its capital strength, a move that laid a solid foundation for the implementation of joint-stock reform.

##### **4.5 Investment by China Investment Co., Ltd.**

The purpose of the establishment of China Investment Co., Ltd. ("CIC") is to realize the diversified investment of national foreign exchange funds and to maximize shareholder income under certain risk conditions, mainly for the national macroeconomic development and the acceleration of economic system reform services. The establishment of CIC is a major measure to implement the strategy of "going out" in our country according to local conditions. CIC has now used foreign exchange to buy some stakes in foreign companies such as PepsiCo.

#### **5. Current Management Mode and Defects of China's foreign Exchange Reserves**

At present, the actual subject of foreign exchange is still the central bank, that is, the central bank independently formulates policies and deployments, and its subordinate units to carry out the measures, supervision and management functions formulated by the higher units. Defects are mainly reflected in: (YI) Large foreign exchange reserves actually increase the opportunity cost of holding foreign exchange, as price fluctuations in the exchange rate and interest rates on the market are difficult to predict accurately. The US economy has been enlivened by quantitative easing by the United States to stabilize its own economy, but this policy has devalued the dollar, especially for a country like China, which is at the forefront of the world's dollar holdings, and any fluctuations in

the dollar could cause our foreign exchange reserves to shrink sharply. (ER)In the operation of foreign exchange reserves China's lack of experience, the scope is not broad enough, China's lack of high-end talent at this stage is also an important issue to improve the management system

## **6. Suggestions on China's Management of Huge Foreign Exchange Reserves[8]**

### **6.1 Transforming the Mode of Economic Growth.**

The serious spillover of China's consumption is an important breakthrough in economic development, mainly by stimulating domestic demand to drive economic growth. Increased means of using foreign exchange reserves. For example, to allow ordinary residents to have more kinds of means to buy and sell foreign exchange, the spread of foreign exchange in residents and enterprises, to achieve the goal of dispersing risk. Encourage Chinese enterprises to invest abroad. Overseas investment can not only obtain resources, but also learn some advanced management experience from developed countries. The Government should actively cooperate, reasonably relax the approval system for enterprises, and encourage Chinese enterprises to achieve the country's economic goals while earning greater profits for the country.

### **6.2 Perfecting the Exchange Rate System[6].**

Accelerate the reform of the RMB exchange rate system.

Since the size of foreign exchange reserves in any country is closely related to the national currency, the expected judgment of RMB exchange rate should be strengthened. China also should set different management objectives for foreign exchange reserves of different sizes, and establish a comprehensive management system under the condition of clear objectives.

### **6.3 Diversifying the Main Body of Foreign Exchange Reserve Assets and Reserves Investment.[7]**

Reduction in the share of the United States dollar in the reserve currency. Long-term export-oriented strategies have accumulated large amounts of dollars in China, which makes China increasingly dependent on the dollar, so reducing dollar holdings is of great significance. Increase the currency types in foreign exchange reserves, such as the euro, the Japanese yen and so on. Diversification of the proportion of foreign exchange reserves can effectively reduce the risk of shrinking foreign exchange reserves. Through the private and other enterprises facing less policy obstruction, promote the process of diversification of foreign investment of large and medium-sized enterprises. At the same time, the Government should give full play to the role of its foreign exchange management subject in access to information channels or public services, and take the initiative to provide more policy support to private enterprises[9].

### **6.4 Speeding up the Process of RMB Internationalization.**

The importance of the internationalization of the renminbi lies in the fact that it is based on China's actual national conditions, the internationalization of the renminbi as a long-term strategy, resulting in an increase in the number of foreign holdings of the renminbi, some Asian countries in the settlement of the renminbi demand, which shows that the internationalization of the renminbi will slowly replace the current dollar part of the settlement function, We can properly alleviate the problem of excessive foreign exchange reserves in China.

### **6.5 Establishing and Perfecting the Implementation of Foreign Exchange Reserve Risk Early Warning System.**

Establish a relatively perfect risk early warning system, prepare for all possible risks, classify risks and preview them, set up a special risk management department and bring together high-quality economic talents to do long-term research.

### **6.6 Establishing Strategic Resource Reserve.**

The most important of the strategic resources is oil. As a big country of oil consumption, China

should draw lessons from foreign countries in terms of resource reserves, learn from foreign excellent experience, and establish a long-term mechanism.

To sum up, making full use of foreign exchange resources can simultaneously achieve the goal of establishing and perfecting oil and other strategic resource reserve systems while managing large foreign exchange reserves.

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