USCC Economic Issue Brief
No. 2 | March 21, 2014

China's Foreign Exchange Reserves and Holdings of U.S. Securities

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Persistent intervention in the exchange rate markets to keep the RMB undervalued has allowed China to accumulate the world's largest reserves of foreign exchange, most of which is in U.S. dollars. By year-end 2013, China had over $3.82 trillion in foreign exchange reserves, nearly double the figure five years earlier. A significant proportion of these reserves is invested in U.S. Treasury securities because Treasuries are seen as a safe investment; are denominated in dollars; and constitute the only financial market base vast enough to accommodate China's surplus liquidity. To date, because China continues to undervalue its currency (and therefore must purchase U.S. dollars), China's efforts to reduce its dependence on U.S. securities necessarily have been modest.

Key Points

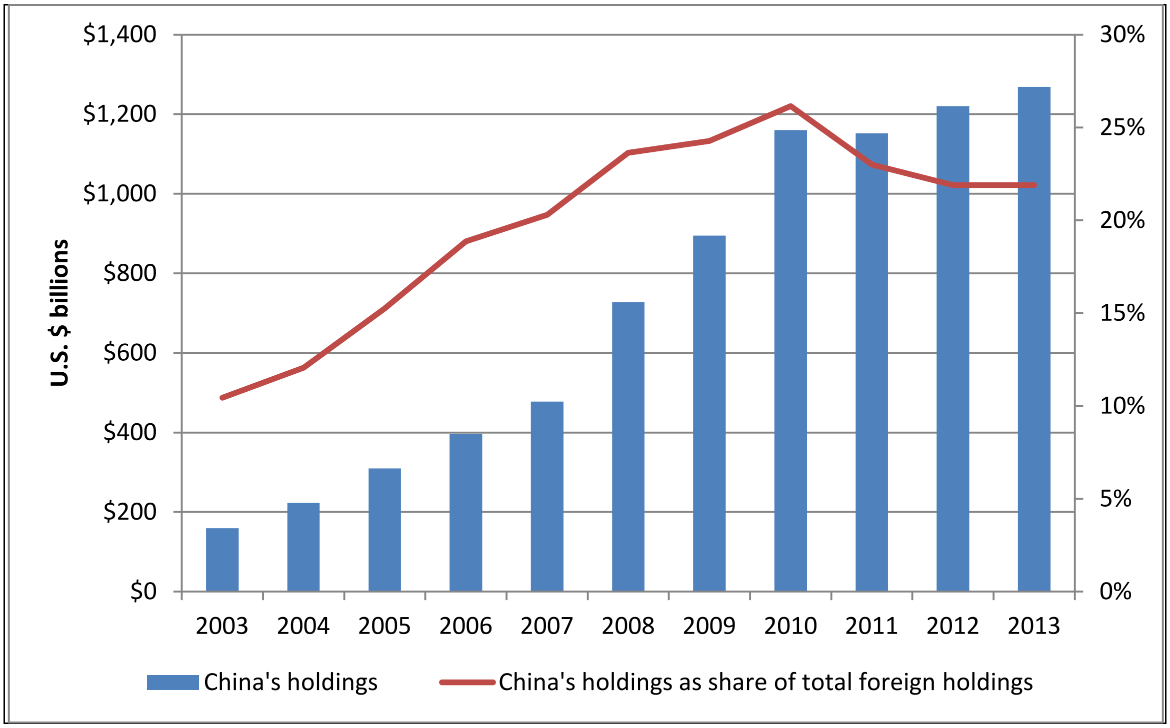
- China pursues an exchange rate policy that keeps its currency undervalued. This requires China's central bank to purchase U.S. dollars entering China's economy, resulting in massive foreign exchange reserves ($3.82 trillion by the end of 2013).
- A significant portion, $1.3 trillion as of December 2013, of China's foreign exchange reserves was invested in U.S. Treasury securities.
- Official data does not fully account for China's holdings of U.S. securities due to constrained data availability and significant time lags. This is compounded by China's secrecy on the composition and allocation of its foreign exchange reserves and by China's unregistered purchases of U.S. Treasuries on the secondary market.
- Despite announcing its intention to diversify its portfolio, China has been slow to move away from Treasuries, largely due to the fact that no other market is large enough to accommodate China's reserves.

U.S. Securities

As China's foreign exchange reserves have risen, so have its holdings of U.S. securities. U.S. Treasury securities, which allow the federal government to finance its budget deficit, are the largest category of U.S. securities held by China.[*] As indicated in figure 1, China's official holdings of U.S. Treasury securities have been growing exponentially to reach $1.3 trillion as of December 2013, making China the largest foreign holder of U.S. Treasury securities[†] (it overtook Japan as the largest holder in 2008).[1]

[*] Data on China's holdings of U.S. securities exclude holdings by Hong Kong and Macau. Though they are part of China, these territories are reported separately by the U.S. Treasury Department.
[†] American households and the U.S. government itself are the biggest holders of U.S. Treasury debt. While China accounts for about 22 percent of all Treasuries held by foreigners, its share is about 10 percent when domestic holders are included.

Figure 1: China's Year-End Holdings of U.S. Treasury Securities, 2003-2013
(US$ billions and as percent of total foreign holdings)



Source: U.S. Department of the Treasury, Major Foreign Holders of Treasury Securities, February 18, 2014.

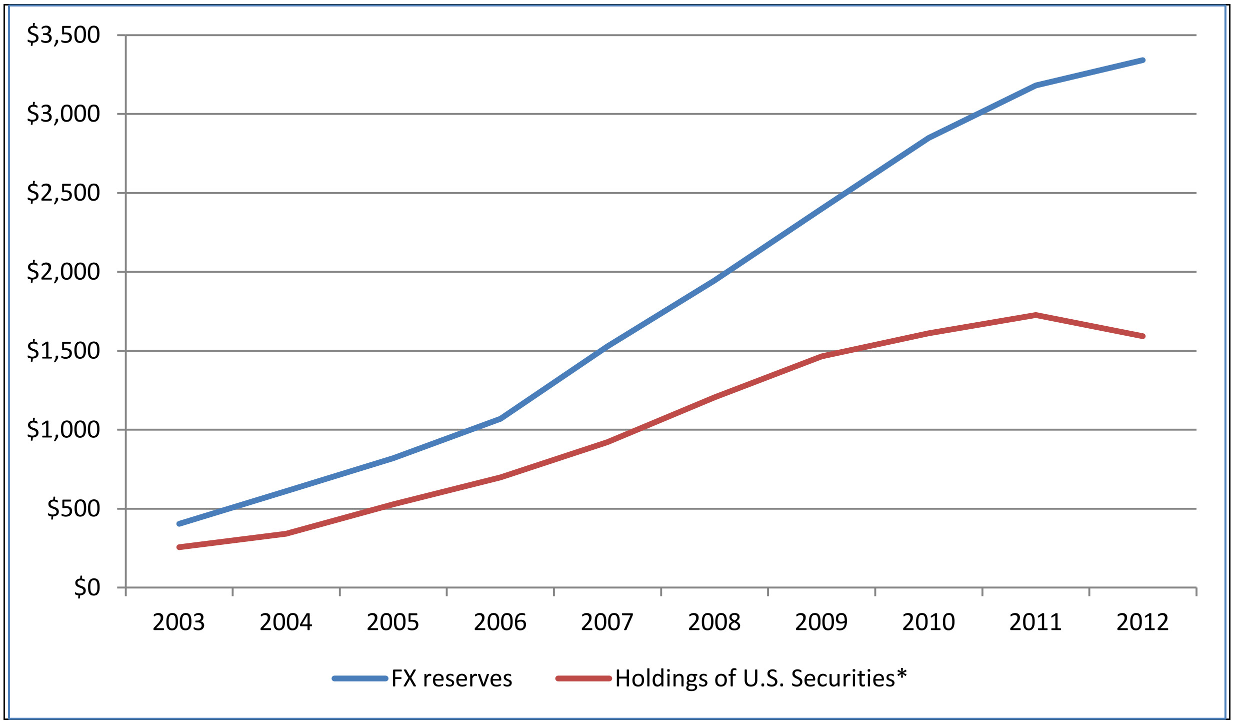
The U.S. Treasury Department's release of December 2013 figures on China's holdings of Treasuries gave rise to speculation that China was increasing its pace of diversification, showing as it did a $47.8 billion decline from November 2013. Year-on-year, however, China's holdings increased by $48.5 billion.

To a lesser extent, Chinese investors also hold U.S. government agency instruments (such as bonds and securities issued by Freddie Mac and Fannie Mae, largest U.S. mortgage-finance companies), non-government corporate securities, and equities (such as stocks). U.S. Treasury Department reporting on foreign portfolio holdings of U.S. securities lags behind reporting on holdings of Treasuries, and is therefore less complete. The latest survey was issued on April 30, 2013, and shows foreign holdings as of June 2012.[2]

Figure 2 shows China's holdings of U.S. securities and its total foreign exchange reserves. The two values tracked each other fairly closely until about 2007, when China's investment in U.S. securities started to moderate, even as foreign exchange reserves continued their steep climb. This trend is a clear evidence of the diversification of China's foreign exchange reserves away from Treasuries.

Although U.S. securities (mostly Treasuries) continue to account for the lion's share of China's officially registered foreign exchange reserves, their proportion has declined from around 63 percent in 2003, to less than 50 percent in 2012.

Figure 2: China's Foreign Exchange Reserves and Holdings of U.S. Securities, 2003-2012
(US$ billions)



*Note: Data on foreign exchange reserves are end of year; data on holdings of U.S. securities are through the end of June.
Source: Chinese State Administration of Foreign Exchange (SAFE); U.S. Treasury Department, *Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2012*, April 2013.

Alternative Avenues for Investment

Some of the decline in holdings of U.S. securities can be explained by China's purchase of these assets through banking centers in London and elsewhere, which would not be recorded by the U.S. Treasury Department. Caribbean tax havens, including the Bahamas, Bermuda, and Cayman Islands, are the third largest holders of Treasuries, behind China and Japan, according to official records. The ultimate owners of these bonds are unknown but likely include the People's Bank of China and its subsidiary, the State Administration of Foreign Exchange (SAFE).

China does not disclose the allocation of its foreign exchange reserves among currencies. This information is considered a state secret, although reliable estimates calculate that 60 to 70 percent of China's foreign exchange is in U.S. dollar-denominated assets, such as Treasuries. Still, if a smaller share of China's foreign exchange reserves is invested in Treasuries, where is the rest invested?

One explanation may flow from China's growing willingness to manage money in less conservative ways—for example, through sovereign wealth funds (SWFs). The establishment of China Investment Corporation (CIC), China's premier SWF, in 2007 corresponds to the divergent trend between China's growth in foreign exchange reserves and investment in U.S. securities. Following an initial endowment, the money managed by CIC is not counted as official reserves. The stated objective of China's SWFs (it has several less-publicity-friendly ones in addition to CIC) is to diversify China's outsized foreign exchange reserves from Treasuries into higher-yielding assets. But these funds are also deployed strategically to secure resources, support domestic Chinese firms, and increase China's diplomatic influence. After a rough start, with a few loss-making deals, CIC has been steadily investing in major U.S. companies in energy and financial services and generating healthy returns.

Another avenue is foreign direct investment (FDI). In 2001, the Chinese government officially adopted a policy encouraging Chinese companies to invest abroad. This "going out" policy has started to show results, although outward investment still pales in comparison to inward investment. According to the latest available Chinese government statistics, outward investment in 2012 reached $87.8 billion (an increase of 17.6 percent year-on-year), with the total accumulation at that time at $531.94 billion. Chinese companies have made major acquisitions of mining and other natural resource companies in Australia, Canada, and parts of Africa, while Chinese brands like Haier (home appliances), Huawei (telecommunications), and Lenovo (personal computers) are seeking to tap global markets, in part through direct investment abroad. Hong Kong is the top destination for Chinese FDI, accounting for over half of the total outflows in 2012, which suggests that Hong Kong is being used as a conduit for Chinese seeking to invest abroad.

In 2012, the United States was the second biggest recipient of Chinese FDI. Although Chinese FDI in the United States remains low, there is a clear upward trend, and it is expected to grow substantially. One reason is that Beijing has become increasingly aware of the risk of having most of its foreign exchange reserves invested in low-interest-bearing Treasuries and is looking to diversify its investments. In addition, U.S. leadership in technology and services has made the United States an attractive prospect for Chinese investors seeking to increase their competiveness at home and abroad.[3] By official U.S. estimates, the total stock of Chinese FDI in the United States at the end of 2012 was $10.5 billion.[‡]

Other Foreign Assets

Investment in the securities of other governments is another possibility, although Chinese efforts to diversify from U.S. assets in a significant way have been stymied by continued global economic weakness and the dearth of markets deep enough to absorb China's trillions. The EU and Japan are the two likeliest candidates, given their close economic ties with China as well as sophisticated financial systems. Available evidence, however, does not show that China has entered either of the markets in a significant way.

European Union

In the aftermath of the global financial crisis, high-raking Chinese officials indicated interest in investing in European assets. For example, in February 2012, Chinese Premier Wen Jiabao, speaking at the EU-China summit, said, "Europe is a main investment destination for China to diversify its foreign-exchange reserves."[4]

So far, there are no indications that China has taken on significant exposure to the riskier bonds denominated in euros. The European Central Bank does not keep a public tracking of

[‡] Using the "ultimate beneficiary owner" method. Unlike the standard reporting method, which attributes each investment to the first and direct purchaser of record, the method known as "country of ultimate beneficiary owner" attempts to track the investment to the actual owner. U.S. Bureau of Economic Analysis, Foreign Direct Investment in the U.S.: Balance of Payments and Direct Investment Position Data. *http://www.bea.gov/international/di1fdibal.htm.*

the nationality of foreign investors in the euro debt market and does not publicly aggregate or coordinate data on foreign purchases of public debt in the 27 member states.[5]

Analysts estimate that about a quarter of China's foreign reserves are held in euro-denominated assets, most of which appear to be concentrated in the more economically stable countries.[6] Since the European financial crisis began, China has purchased a limited amount of European bonds from individual states. Stephen Green, China economist at Standard Chartered, noted that the majority of China's bond purchases in Europe has likely been in core eurozone countries like Germany that boast relatively low debt levels. Chinese officials have privately indicated that they "are wary of buying bonds directly from Greece, Portugal and other troubled European nations."[7] Indeed, although Germany has the highest sovereign bond rating among eurozone countries, China's portfolio investment in Germany amounted to only €67.5 billion by the end of 2013.[8] Comments by Chinese officials have indicated that they would prefer to help with Europe's sovereign bailout through the IMF rather than buying bonds directly.[§]

Estimates of Chinese holdings in the European Financial Stability Facility (EFSF)[**] bonds similarly rely on educated guessing. The facility categorizes bond purchases by region, rather than by individual purchasers.[9] In 2013, Asian investors, a separate category, purchased between 10 and 45 percent of the long-term bonds, depending on the issuance.[10] In a 2014 official presentation to investors, the European Stability Mechanism (ESM), EFSF's permanent successor, reported that Asian investors accounted for purchases of 22 percent of EFSM bonds and 35 percent of ESM bonds.[11] The assumption is that China holds around 40 percent of the issues held by Asian investors.[12] Even by the most generous estimates of China's share, the total amounts are small: EFSF issued €250 billion long-term bonds, while ESM only €10 billion.[13]

Japan

Chinese purchases of Japan's government debt market prompted some Japanese officials to complain that Chinese investments increased volatility and caused the yen to strengthen.[14] According to the Japanese Ministry of Finance and the Bank of Japan, in 2011 China held short-term and long-term Japanese government bonds worth 18 trillion yen ($230 billion), a comparatively miniscule amount.[15] Though still small, China's holdings of Japanese portfolio assets have been growing: From $8.5 billion in 2003 to $285 billion 2012, according to IMF's Coordinated Portfolio Investment Survey data.[16]

Conclusion

Although available data show that China is indeed attempting to diversify its foreign exchange holdings by investing less in Treasuries, this transition is happening very slowly. Until China renounces the policy of intervening in the foreign exchange market for the purpose of keeping the RMB undervalued, China is going to remain a major purchaser of U.S. government securities.

[§] For example, while Zhou Xiaochuan, the governor of China's central bank, said that China would increase its participation through the IMF, the European Financial Stability Facility (EFSF), and the future European Stability Mechanism (ESM), Premier Wen Jiabao stressed that any further investment in euro debt will happen in line with the principles of security, liquidity, and value preservation. *China Daily,* "Investment Will Continue," February 16, 2012.

[**] The EFSF, created in 2010, is a special-purpose vehicle financed by members of the eurozone to address the European sovereign debt crisis. It provides financial assistance to eurozone states in economic difficulty. The facility is authorized to borrow up to €440 billion, of which €250 billion remained available after the Irish and Portuguese bailout. ESM, the facility's permanent successor, was established in September 2012, and will function as a permanent firewall for the eurozone with a maximum lending capacity of €500 billion.

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[1] U.S. Department of the Treasury, "Major Foreign Holder of Treasury Securities," February 18, 2014. *http://www.treasury.gov/resource-center/data-chart-center/tic/Documents/mfh.txt*.

[2] Department of the Treasury, Federal Reserve Bank of New York, and Board of Governors of the Federal Reserve System, *Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2012*, April 2013. *http://www.treasury.gov/resource-center/data-chart-center/tic/Documents/shla2012r.pdf*.

[3] U.S.-China Economic and Security Review Commission, "Trends in Chinese Investment in the United States," *2013 Annual Report to Congress* (Washington, DC: November 2013), p. 95. *http://origin.www.uscc.gov/sites/default/files/Annual_Report/Chapters/Chapter%201%3B%20Section%202%20Trends%20in%20Chinese%20Investment%20in%20the%20United%20States.pdf*.

[4] Tom Orlik and Bob Davis, "Beijing Diversifies Away from U.S. Dollar," *Wall Street Journal*, March 1, 2012.

[5] For more on the EU's investment reporting standards, see François Godement and Jonas Parello-Plesner, "The Scramble for Europe," *ECFR/37* [European Council on Foreign Relations] (July 2011); and Thilo Hanemann and Daniel H. Rosen, "China Invests in Europe: Patterns, Impacts and Policy Implications" (New York: Rhodium Group, June 2012), pp. 68-72.

[6] Aileen Wang and Nick Edwards, "China to Keep Investing in Euro Zone Debt: China Central Bank," Reuters, February 15, 2012. *http://www.reuters.com/article/2012/02/15/us-china-europe-idUSTRE81E07J20120215*.

[7] Tom Orlik and Bob Davis, "Beijing Diversifies Away from U.S. Dollar," *Wall Street Journal*, March 1, 2012.

[8] Deutsche Bundesbank, "Time series BBK01.ED1277: Foreign investment in Germany / China, People's Republic of / Portfolio investment / Total / Balance." *http://www.bundesbank.de/Navigation/EN/Statistics/Time_series_databases/Macro_economic_time_series/its_details_value_node.html?tsId=BBK01.ED1277*.

[9] The European Financial Stability Facility numbers can be found at *http://www.efsf.europa.eu/.*

[10] The European Financial Stability Facility (Luxembourg) issuances, various series. *http://www.efsf.europa.eu/investor_relations/issues/index.htm*.

[11] "European Financial Stability Facility & European Stability Mechanism," February 2014. *http://www.esm.europa.eu/pdf/EFSF%20ESM%20New%20Investor%20presentation%20February%202014.pdf.*

[12] U.S.-China Economic and Security Review Commission, *Hearing on the China-Europe Relationship and Transatlantic Implications,* written testimony of Jonas Parello-Plesner, April 19, 2012.

[13] ESM, "ESM Long-Term Funding," *http://www.esm.europa.eu/investors/inaugural-bond/index.htm*.

[14] See for example, Michiyo Nakamoto and Geoff Dyer, "Japan Alarm over China's JGB Purchases," *Financial Times*, September 2010; Tatsuo Ito, "Imbalance Seen in Japan-China Deal," *Wall Street Journal*, February 2, 2012.

[15] "China's Japanese bond holdings hit all-time high," *Shanghai Daily*, June 5, 2012. *http://china.org.cn/business/2012-06/05/content_25564500.htm.*

[16] IMF Coordinated Portfolio Investment Survey, "Japan Table 4: Table 4: Reported Portfolio Investment Liabilities by Economy of Nonresident Holder: TOTAL PORTFOLIO INVESTMENT." *http://elibrary-data.imf.org/Report.aspx?Report=9492641&Country=158.*