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China's $1.7 Trillion Bet

China's External Portfolio and Dollar Reserves

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Introduction

China reported $1.95 trillion in foreign exchange reserves at the end of 2008. This is by far the largest stockpile of foreign exchange in the world: China holds roughly two times more reserves than Japan, and four times more than either Russia or Saudi Arabia. Moreover, China's true foreign portfolio exceeds its disclosed foreign exchange reserves. At the end of December, the State Administration of Foreign Exchange (SAFE)—part of the People's Bank of China (PBoC) managed close to $2.1 trillion: $1.95 trillion in formal reserves and between $108 and $158 billion in "other foreign assets." China's state banks and the China Investment Corporation (CIC), China's sovereign wealth fund, together manage another $250 billion or so. This puts China's total holdings of foreign assets at over $2.3 trillion. That is over 50 percent of China's gross domestic product (GDP), or roughly $2,000 per Chinese inhabitant.

If 70 percent of this has been invested in dollar-denominated financial assets, China's dollar portfolio tops $1.7 trillion—a bit under 40 percent of China's GDP. The authors estimate that China held close to $900 billion of Treasury bonds (including short-term bills) at the end of the fourth quarter, another $550 billion to $600 billion of agency (Fannie Mae, Freddie Mac, and Ginnie Mae) bonds, $150 billion of U.S. corporate bonds, and $40 billion of U.S. equities, as well as $40 billion in short-term deposits. These estimates are significantly larger than the numbers reported in the U.S. Treasury data, as those data tend to understate recent Chinese purchases and thus total holdings of U.S. assets.

The pace of growth of China's foreign assets clearly slowed in the fourth quarter of 2008. But it slowed after a period of unprecedented foreign asset growth. From the fourth quarter of 2007 to the third quarter of 2008, China likely added over $700 billion to its foreign portfolio (more than implied by the increase in its formal reserves). One fact illustrates just how rapid the growth in China's foreign assets exceeded the rise in combined foreign assets of the world's oil-exporting countries. As a result, China's government is now by far the largest creditor of the United States: during the period of its peak growth, it likely lent about $475 billion (roughly $40 billion a month) to the United States. Never before has a relatively poor country lent out so much money to a relatively rich country. And never before has the United States relied on a single country's government for so much financing.

China's outsized impact on global capital flows is a relatively recent development—one directly tied to China's policy of managing its exchange rate against the dollar. In the 1990s, China did not have to intervene in the currency market on a huge scale to maintain its peg to the dollar. From 1995 onward the dollar, and thus the renminbi, generally was appreciating and China's overall trade surplus remained modest. Direct investment inflows were offset by other kinds of capital outflows. In 2000, for example, China only added $15 billion to its reserves. The dollar's post-2002 depreciation was combined with tight fiscal policy and limits on domestic lending by the state banks to offset the inflationary impact of China's depreciated currency. This resulted in a large increase in China's trade and current account surplus. The current account surplus reached 11 percent of China's GDP in 2007—and its expansion drove most of the growth in China's reserves.