Moves by China to Improve How It Manages Its Foreign Exchange Reserves

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I. China Investment Corporation's planned capital increase

1. China Investment Corporation

China Investment Corporation (CIC) was established in September 2007 using some of China's foreign exchange reserves as capital. After overtaking Japan as the world's largest holder of foreign exchange reserves in February 2006, China saw its foreign exchange reserves break the $3 trillion barrier and grow to $3,044.7 billion by end-March 2011. Some 70% of these reserves are reported to be denominated in US dollars, with most of this amount managed by the State Administration of Foreign Exchange (SAFE), an arm of the People's Bank of China, in the form of US Treasury securities. The choice of US Treasuries can be attributed to China's need to make trade payments in US dollars and to the liquidity of the US Treasury market. However, CIC has been assigned the task of reducing the downside risk and improving the return on the assets it manages.

CIC is a wholly state-owned company under the direct control of the State Council and has the task of maximizing long-term risk-adjusted returns in accordance with the principles of (1) separating business and politics, (2) allowing companies to operate independently of the state, and (3) pursuing commercial goals. More than 50% of its initial capital of $200 billion, which was set aside from China's foreign exchange reserves, is invested overseas. In 2009 it achieved a return of 11.7% on its overseas investments (compared with –2.1% in 2008) and an overall return on equity of 12.9% on its overseas and domestic investments (the latter consisting of investments in domestic financial institutions) combined (compared with 6.8% in 2008)[1]. Although the corresponding figure for 2010 has not yet been officially announced, it is reported to be more than 11%[2].

[1] For more on CIC's performance in 2009, see Sekine, Eiichi, "The Governance of China Investment Corporation/China Investment Corporation on Its Way to Becoming a Sophisticated Institutional Investor," Nomura Journal of Capital Markets, Winter 2011, Vol.2, No.3.
[2] See Caijing, 12 May 2011.

2. Moves to increase CIC's capital

As of end-2009, CIC's total assets stood at $332.4 billion, meaning it has used up all of its initial capital of $200 billion, and it was first reported at the time of the 3rd Plenary Session of the 11th National People's Congress in March 2010 that CIC had applied to the State Council for a capital increase. Although nothing came of this in 2010, it has been reported that CIC reshuffled its portfolio that year by switching out of developed markets and into emerging markets in order to improve the return on its portfolio.

Wang Jianxi, Executive Vice President and Chief Risk Officer of CIC, was also reported to have said during the 4th Plenary Session of the 11th National People's Congress in March 2011 that CIC had used up all of its initial capital and had applied to the State Council for more but had not yet received a reply. Then, in April 2011, the *Financial Times*[3] reported that China's Ministry of Finance was set to grant CIC $100–200 billion of new capital. Jin Liqun, Chairman of CIC's Board of Supervisors, confirmed at a meeting of the International Forum of Sovereign Wealth Funds (IFSWF) in Beijing on 12 May 2011 that the Chinese government was indeed considering increasing CIC's capital but said that no final decision had been made on the amount and timing of the increase[4].

3. Three options for CIC to increase its capital

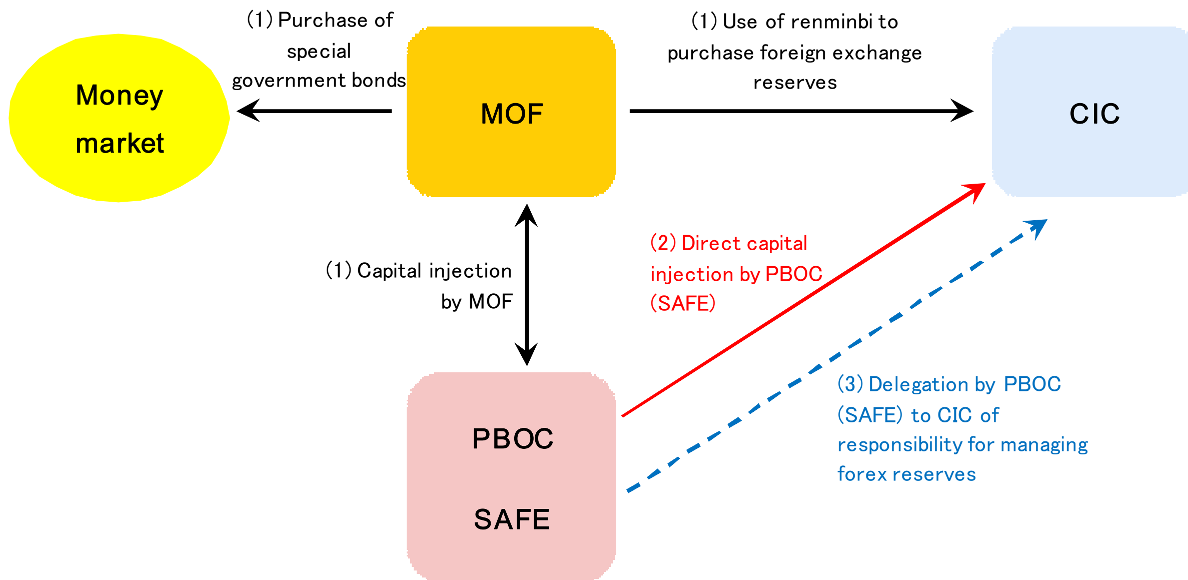
We understand that three options are under consideration to increase CIC's capital (Figure 1)[5].

1) First option: issue of special government bonds by China's Ministry of Finance (MOF) to purchase foreign exchange reserves and inject capital into CIC

The option chosen when CIC was established in September 2007 was for MOF to issue special government bonds. One of the reasons for establishing CIC was to reduce China's foreign exchange reserves and generate a higher return on them. However, simply investing China's foreign exchange reserves overseas would not have reduced surplus domestic liquidity (by a corresponding amount). It was therefore decided to issue renminbi-denominated bonds on the domestic market to mop up some of this surplus liquidity, then to inject a corresponding amount of foreign exchange reserves into CIC as its initial capital[6]. The choice of this scheme also

3 See "CIC set for up to $200bn in fresh funds," Financial Times, 25 April 2011.
4 See Caijing, 12 May 2011.
5 See Caijing, 14 March 2011 and First Financial Daily, 25 March 2011.
6 For further details of the events leading up to CIC's establishment, see Sekine, Eiichi, "Chuugoku no Gaika Junbi Un'yougaisha no Setsuritsu ni Muketa Ugoki" (Moves towards Setting Up a Company to Manage China's Foreign Exchange Reserves), Kikan Chuugoku Shihon Shijou Kenkyuu, 2007 Autumn edition, Tokyo Club Foundation for Global Studies (in Japanese).

Figure 1: Three options for CIC to increase its capital



Source: Nomura Institute of Capital Markets Research, from various media reports

reflected the recognition that simply issuing T-bills would not be enough to absorb this surplus liquidity.

The capital increase could be financed in the same way as CIC's initial capital: namely, by issuing special government bonds. However, this could be problematic. The first problem is that any issuance of special government bonds would, under China's *Budget Law*, have to be approved by the Standing Committee of the National People's Congress. That would take time. The second problem is the need to take account of the impact on the market of a large issue of special government bonds. When CIC was established in 2007, MOF issued a total of RMB1,550 billion in special government bonds in eight tranches. The third problem is the fact that the People's Bank of China is prohibited from directly underwriting government bonds. In order to circumvent this when CIC was established in 2007, the special government bonds issued by MOF were first underwritten by Agricultural Bank of China before being purchased by the People's Bank of China. As Agricultural Bank of China is now a listed joint stock company, however, the first option could involve policy banks such as China Development Bank or China Exim Bank in order to circumvent the prohibition.

2) Second option: direct stake by SAFE in CIC

The second option would be for SAFE to take a direct stake in CIC. As a result, MOF would become a joint shareholder (along with the People's Bank of China) in CIC instead of, as at present, the sole shareholder. This would probably affect the membership of CIC's board of directors, currently controlled by MOF (Figure 2). We

Figure 2: CIC's board of directors (as of June 2011)

Position	Name	Other positions
Chairman & Chief Executive Officer	Lou Jiwei	Previously Deputy Secretary General of the State Council (formerly Deputy Minister of Finance)
Vice Chairman, President & Chief Investment Officer	Gao Xiqing	Previously Vice-Chairman of the National Council for the Social Security Fund (formerly Vice-Chairman of the China Securities Regulatory Commission)
Vice President & Chief Operating Officer	Zhang Hongli	Formerly Deputy Minister of Finance
Non-executive Director	Zhang Xiaoqiang	Deputy Chairman of the National Development and Reform Commission
Non-executive Director	Li Yong	Deputy Minister of Finance, Director of the National Council for the Social Security Fund
Non-executive Director	Chen Jian	Deputy Minister of Commerce
Non-executive Director	Hu Xiaolian	Deputy Governor of the People's Bank of China
Non-executive Director	Fang Shangpu	Deputy Administrator of the State Administration of Foreign Exchange
Independent Director	Liu Zhongli	Director of the National Council for the Social Security Fund, formerly Deputy Secretary General of the State Council and Minister of Finance
Independent Director	Wang Chunzheng	Formerly Deputy Chairman of the National Development and Reform Commission
Employee Director	Li Xin	Head of CIC's Human Resources Department, ex-Ministry of Finance

Note: Shading indicates association with or former position with Ministry of Finance.
Source: Nomura Institute of Capital Markets Research, from CIC's website

can therefore imagine that MOF might not be happy about the changes to CIC's governance that a direct stake by SAFE in CIC would probably entail.

3) Third option: delegation by SAFE to CIC of responsibility for managing foreign exchange reserves

The third option would be for SAFE to delegate to CIC the responsibility for managing China's foreign exchange reserves. Although this option would not affect CIC's governance in the way that the second option would, the fact that SAFE has been seeking to diversify the way it itself manages the reserves (see below) raises a number of possible complications (e.g., the need to agree an expected rate of return with CIC and the size of the mandate CIC could expect from SAFE).

However, whichever of these three options is chosen, an increase in CIC's capital is likely to result in CIC increasing its overseas investments. We understand that the various options have been presented to the government, that a decision is expected by the end of this year, and that fresh capital will be injected at a rate of several tens of billions of dollars a year rather than at one go[7].

7 See Century Weekly, 16 May 2011.

II. SAFE intent on diversifying the way it manages China's foreign exchange reserves

As well as its *Guidelines* the CBRC has published a press release and a Q&A document on the New Standards. We conclude from these that the CBRC's response to Basel III is to try to impose the following regulatory standards on Chinese banks and then improve those standards.

1. SAFE's moves to diversify the way it manages China's foreign exchange reserves an extension of existing policy

On 1 December 2009 SAFE published its *Overview of Foreign Exchange Administration*. This was followed, in July 2010, by its publication of *FAQs on Foreign Exchange Management Policies*. In both documents SAFE makes it clear that its management of China's foreign exchange reserves is governed by three criteria: safety, liquidity, and return. The documents also reveal that SAFE invests in assets such as government bonds, agency bonds, supranational bonds, corporate bonds, and investment funds, while it not only invests in major international currencies such as the US dollar, the euro, and the yen but is also seeking to diversify into emerging market currencies as part of its policy of international diversification.

SAFE began to invest in individual companies such as European resource stocks and financials before the collapse of Lehman Brothers in September 2008 but put this on hold for a time when the global financial crisis deepened. However, it seems to us that SAFE may now be looking to improve the return on the assets it itself manages—perhaps with one eye on CIC's performance since 2009.

2. China diversifies its bond investments

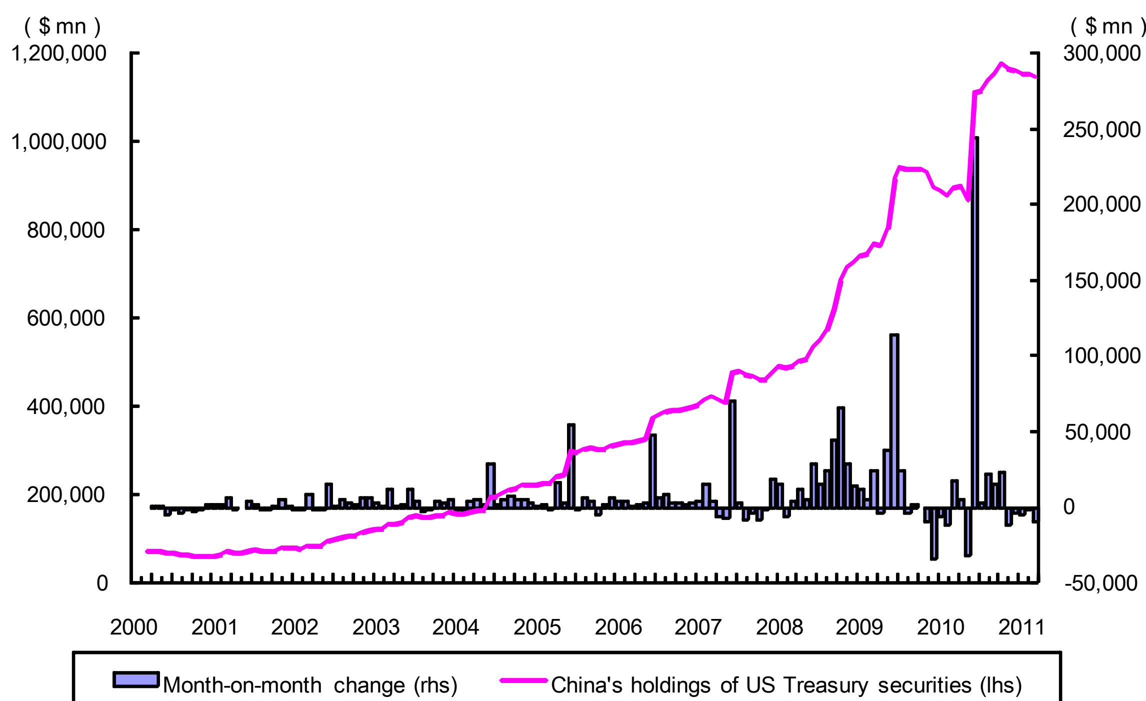
Since 2010, China has begun to diversify how it invests its foreign exchange reserves, especially in bonds.

1) US Treasury securities

The first change is a decline in China's holdings of US Treasury securities. According to the figures through 2009, these peaked (on a stock basis) at $939.9 billion in July of that year and then began to decline (Figure 3). A monthly (net) decline of $32.5 billion in May 2010 was particularly noticeable.

According to figures released by the US Treasury Department on 28 February 2011 and back-adjusted to June 2010, China's holdings of US Treasuries peaked at $1,175.3 billion at end-October 2010 and then began to decline. As of end-March 2011, they stood at $1,144.9 billion, a decline of $30 billion over five months. This decline in China's holdings of US Treasuries over a period when China's foreign exchange reserves increased by $283.8 billion from $2, 760.9 billion to $3,044.7 billion gives

Figure 3: China's holdings of US Treasury securities and month-on-month change thereof



Note: Data for 2011 through March. US Treasury Department has revised data back to June 2010 (as released on 28 February 2011).
Source: Nomura Institute of Capital Markets Research, from CEIC data

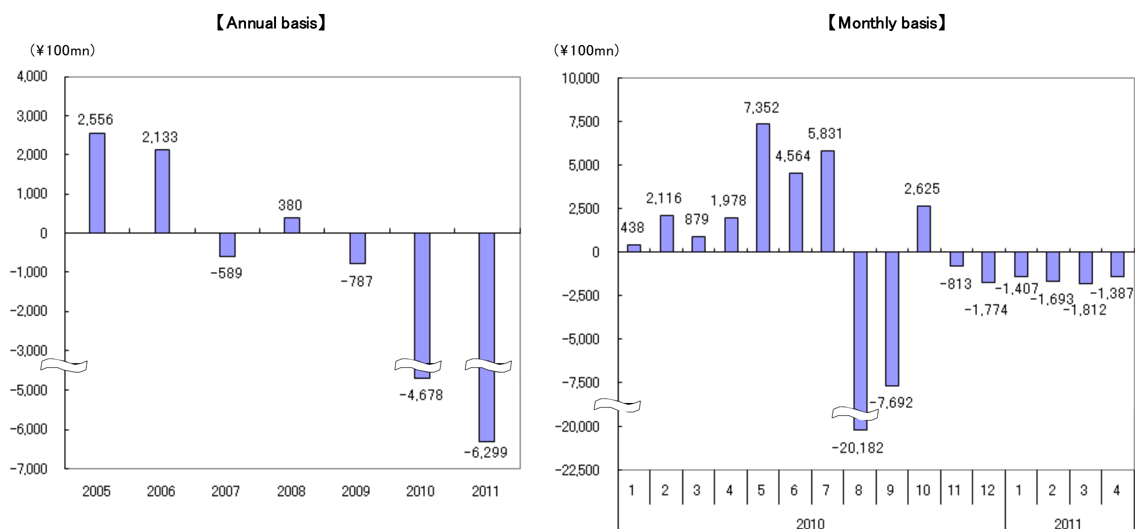
some indication of the extent to which it has diversified how it invests those reserves into assets other than US Treasuries in reaction to dollar depreciation and the downgrading of US Treasuries.

2) Japanese bonds

The second change is in China's sales and purchases of Japanese (government) bonds. Since 2010, Chinese sales and purchases of Japanese bonds have increased significantly. In the first seven months of 2010, for example, China purchased a net ¥2,315.8 billion of Japanese bonds (Figure 4). Of this amount, ¥2,361.3 billion consisted of net purchases of short-term bonds with a maturity of less than 12 months, while ¥45.5 billion consisted of net sales of medium- and long-term bonds. We can therefore say that China was typically a net purchaser of short-term bonds during this period. However, in August 2010, China sold a net ¥2,018.2 billion of Japanese bonds, offsetting most of its net purchases during the preceding seven months.

China has remained a net seller of Japanese bonds in general since September 2010 and has been seen as seeking to gain from the strength of the yen. However, it has remained a net purchaser of medium- and long-term Japanese bonds since October 2010. In particular, it purchased a net ¥165.2 billion in February 2011 and a net

Figure 4: Chinese purchases of Japanese (government) bonds



Source: Nomura Institute of Capital Markets Research, from Japanese Ministry of Finance data

¥234.5 billion the following month, while in April it purchased no less than a net ¥1,330.0 billion. (Including short-term bonds, however, it sold a net ¥138.7 billion in April.) Whether or not China continues to buy more medium- and long-term Japanese bonds is likely to have a significant impact on Japanese fiscal policy and Japan's bond markets.

3) Korean bonds

The third change is in China's purchases of Korean bonds. China's holdings of Korean bonds have risen sharply from KRW79.6 billion at the end of 2008 to KRW1,872.6 billion at the end of 2009 and KRW6,569.5 billion at the end of 2010. In 2010 as a whole China was the second-largest net investor in Korean bonds (excluding refinancing as a result of redemptions) at KRW4,697.0 billion after the US at KRW6,224.1 billion.

When investing China's foreign exchange reserves in bonds, SAFE has take the inflation rates of the countries whose bonds it has bought as a benchmark in order to maintain the purchasing power of its foreign exchange reserves and be able to make trade payments[8]. According to SAFE, the average annual inflation rates of the US, Europe and Japan in 2000–2010 were 2.4%, 2.1% and –0.2%, respectively, while the returns on its investments in those countries' bonds were higher in each case.

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[8] See http://www.safe.gov.cn/model_safe/news/new_detail.jsp?ID=90000000000000000,902&id=3&type=1,2.

3. Moves towards setting up a second fund

China's foreign exchange reserves have continued to increase even since $200 billion of those reserves were used to capitalize CIC when it was established in September 2007 and stood at more than $3 trillion at the end of March 2011 (see above). In this connection, it is perhaps worth mentioning that at a financial seminar at Tsinghua University on 8 April 2011 People's Bank of China Governor Zhou Xiaochuan indicated that he thought that China already had more foreign exchange reserves than it needed and that it should do more to encourage imports and diversify the way it invested its reserves. There have therefore been reports, albeit in the Chinese media, that the Chinese government is considering setting up a second fund to invest some of China's foreign exchange reserves in other assets such as precious metals and sources of energy[9].

In this regard, some in China appear to think that, since CIC is already invested in the energy sector, it would be better if a sovereign wealth fund were to be responsible for investing some of China's foreign exchange reserves in sources of energy[10].

III. Investment in Japanese equities by China's QDIIs

1. What are QDIIs?

As well as establishing CIC and seeking to diversify the way China invests its foreign exchange reserves (see above), the Chinese authorities are hoping to gradually generate more capital outflows in order to soak up some of the surplus liquidity that has been fueling inflation and a possible asset bubble. There are two types of capital outflows: outward direct investment, which seeks to gain control of the companies invested in, and outward portfolio investment, which seeks to earn a return from the companies invested in. In April 2006 the Chinese authorities instituted a system of Qualified Domestic Institutional Investors (QDIIs, pronounced "Cuedees") to allow authorized institutions to engage in outward portfolio investment. Under this system, financial institutions first need to obtain a license from the regulator; then they need to apply to SAFE for an investment quota; and then they can invest in overseas securities up to the amount of their quota. According to product data from those QDIIs that are required to file disclosure documents every quarter (i.e., companies managing mutual funds specializing in overseas equities), RMB52.3 billion (roughly ¥664.2 billion) of the RMB74.3 billion (roughly ¥943.6 billion[11]) in assets they were managing as of end-March 2011 consisted of equities. However, RMB31.9 billion (roughly ¥405.1 billion, i.e., 61%) of these equity holdings consisted of "Hong Kong stocks" (Figure

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9 See Century Weekly, 25 April 2011. The article also says that China's monetary authorities have been considering setting up an equalization fund to enable them to intervene in the foreign exchange market and to reduce the need to rely on the People's Bank of China's monetary policy.

10 See Shihua Caixun, 16 May 2011.

11 We have converted amounts in renminbi as of end-March 2011 to yen using the mid-rate on 31 March 2011 (RMB1 = ¥12.7).

Figure 5: Countries in which 30 QDII stock investment trusts are invested (as of end-March 2011)

	Country/region	As End-March 2011 (RMB mn)	Share (%)
1	Hong Kong	31,873.44	60.97
2	US	6,188.14	11.84
3	Korea	2,979.01	5.70
4	Australia	2,873.82	5.50
5	UK	2,112.58	4.04
6	Singapore	1,309.41	2.50
7	Taiwan	1,209.68	2.31
8	India	1,095.18	2.09
9	Indonesia	582.49	1.11
10	Thailand	526.56	1.01
11	Malaysia	469.48	0.90
12	Japan	361.09	0.69
13	Canada	262.77	0.50
14	France	154.31	0.30
15	China	90.50	0.17
	Total	52,276.71	100.00

Note: 1. Data derived from 30 stock investment trusts, excluding those managed by HuaAn Fund Management Co., Ltd. Only data for top 15 countries/regions shown.
2. The total is slightly erroneous because of differences in the way the data for each fund are collected.

Source: Nomura Institute of Capital Markets Research, from Shanghai Wind Information Co., Ltd. data

5). In fact, although this may be referred to as "outward portfolio investment," the companies whose shares these funds have invested in are Chinese companies listed on the Hong Kong Stock Exchange.

2. Investment in Japanese equities by China's QDIIs

RMB360 million (roughly ¥4.6 billion, i.e., 0.69%) of these equity holdings consisted of Japanese equities. This marks an increase from end-2010, when the figure was RMB290 million (roughly ¥3.6 billion, i.e., 0.53%)[12]. Since these fund management companies benchmark most of their QDII products to global stock indices such as the MSCI, their holdings of Japanese equities had never exceeded 1% of their equity holdings. However, it is noteworthy that they increased their exposure to Japanese equities after the earthquake that struck Japan on 11 March 2011.

As of end-March 2011, seven companies offered exposure to Japanese equities through a total of eight QDII products. The company with the largest holdings in Japanese equities was China Asset Management Co., Ltd. (ChinaAMC), China's largest fund management company. Its holdings of Japanese equities increased from RMB201.37 million as of end-2010 to RMB300.75 million as of end-March 2011, an

[12] We have converted amounts in renminbi as of end-2010 to yen using the mid-rate on 31 December 2010 (RMB1 = ¥12.3).

increase of some RMB100 million. Perhaps not surprisingly, ChinaAMC's parent and China's largest securities company, CITIC Securities, has had close ties with Japan's financial sector ever since the introduction of market-oriented reforms in China in 1978. Just as overseas investors have been net purchasers of Japanese equities since the US Treasury Department announced its second round of quantitative easing (QE2) in the first week of November 2010, the indications are that China's QDIIs have been following suit.

3. Lessons for Japan

CIC has also been in the news with regard to investment in Japanese equities in connection with the earthquake that struck Japan in March 2011. For example, on 23 March 2011, Securities Times Online reported that Wang Jianxi, Executive Vice President of CIC (see above), had said the day before about a report in the Wall Street Journal (namely, that CIC had invested ¥35.9 billion in Tokyo Electric Power Company (TEPCO)) that the investment had actually been considerably less than ¥35.9 billion and that CIC's policy was to invest in a diversified portfolio of international stocks benchmarked to a global index. However, Mr Wang apparently did not give any exact figures. Similarly, Securities Times Online reported that Mr Wang had said about another report in the same Wall Street Journal article (namely, that CIC had invested ¥522.2 billion in 10 leading Japanese companies, including Canon and Sony) that the actual investment was only a fraction of that amount and that CIC was careful about the timing of its Japanese investments and did not react to every short-term change of market direction.

In addition to investments in Japanese equities by Chinese QDIIs, moves to increase CIC's capital or to establish a second fund for investing China's foreign exchange reserves should be seen as possibly giving the Tokyo stock market a boost and as requiring Japanese companies to foster their relations with Chinese investors. We shall continue to monitor China's moves to improve how it manages its foreign exchange reserves.