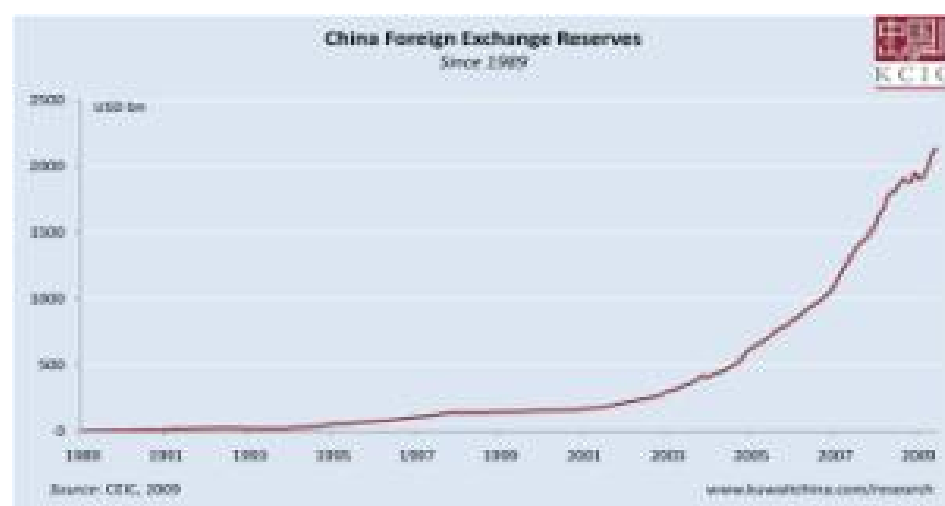


KCIC WEEKLY ANALYSIS

China's FOREX crosses trillion dollar mark



Why is this graph important?

This graph shows that China's stock of foreign exchange reserves has recently crossed the astounding milestone of two trillion US dollar. In fact, China has accumulated the largest amount of reserves in the whole world, accounting for more than 30 percent of all reported foreign exchange reserves. It is widely believed that about 70 to 75 percent of China's reserve assets are in fact held in dollar-denominated assets, mainly US treasury bonds and bills as well as U.S. government agency bonds (e.g. Freddie Mac). As the economic situation in US

deteriorates, China is more likely to divert its foreign exchange reserves away to other investment (especially in China) from these low-return assets in U.S. This shift, if it happens, will lead to increasing pressure on Chinese Yuan to appreciate relative to U.S. dollar. In turn, a stronger Chinese currency will encourage China's domestic consumption by making foreign goods cheaper. The key message here is that China is reaching a point that it has to fine-tune its use of the foreign exchange reserves and this adjustment is very likely to help China move to a more balanced consumption-led growth model.

What does this indicator mean?

Foreign exchange reserves (also called Forex reserves or FX reserves) are the foreign currency deposits and bonds held by central banks and monetary authorities. Reserve accumulation usually can result from the following two channels.

* Trade surpluses, where a nation exports more goods and services to other countries than it imports from other countries. Because only a few currencies (U.S. dollar, Japanese Yen, Euro, etc.) are widely accepted as means of transaction for international trade, most countries have to exchange their local currencies into those currencies when they do business with the rest of the world. When a country exports its goods and services, it earns foreign currency (usually US dollar); when it imports others' goods and services, it spends foreign currency. Therefore, if exports exceed imports, a country is essentially accumulating foreign currency.

* Capital account surpluses, where other countries acquire more assets (physical assets like land or plants, as well as financial assets like equities or bond) of a certain country than the assets that this certain country acquires in other countries. When other countries invest (i.e. acquire assets) in a country, they have to exchange their currencies into the local currency. Likewise, a country needs to exchange its local currency into some widely accepted currencies when making investment abroad.

China has been accumulating FX reserves through both of the above mechanism. More specifically, from 2000 to 2008, trade surpluses contributed nearly four-fifths of China's reserve accumulation thanks to the impressive export growth.

What is the implication?

China has been accumulating FX reserves mainly for two reasons.

- 1) To keep Chinese currency relatively undervalued, thus making Chinese goods competitive in international markets.
- 2) To use it as an insurance against currency and banking crisis.

However, China's continued massive foreign exchange accumulation is incurring more and more cost and benefit to its own economy and to the world economy.

In the short run, it is unlikely that China will aggressively move its money out of US. It takes time and effort to slow the dependence on exports for growth. Any dramatic adjustment in reserves (and exchange rate as a result) will endanger China's near-term economic development. Besides, there are few viable alternatives to USD assets right now. However, Chinese policymakers know that, in the long run, they need to restore the balance between exports and domestic consumption and exchange rate adjustment is an inevitable step towards this goal. Therefore China has begun to diversify into gold and other commodities, and has also agreed to increase its ownership of SDR (Special Drawing Rights, the currency created by IMF) bonds from International Monetary Fund (IMF).