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Not quite so SAFE

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Is China souring on the dollar?

CHINA is America's largest creditor. Thanks to a policy of piling up foreign-exchange reserves and investing most of them in dollar assets, China's government bought around one quarter of the net increase in Treasuries over the past two years. But just as Washington needs to sell record amounts of debt to fund its soaring budget deficit and to bail out its banks, there are signs that Beijing's appetite for American debt may be shrinking.

According to official figures, China's reserves fell in January and February. Taking the first quarter as a whole they rose by just $8 billion, compared with $154 billion a year earlier. Chinese officials have voiced pointed public worries about the effect of America's massive fiscal and monetary expansion on the value of China's dollar holdings. In a high-profile essay, Zhou Xiaochuan, the governor of the People's Bank of China (PBOC), recently floated the idea of a global reserve currency. The combination of falling reserves and rising rhetoric has fuelled fears that China is turning its back on the greenback.

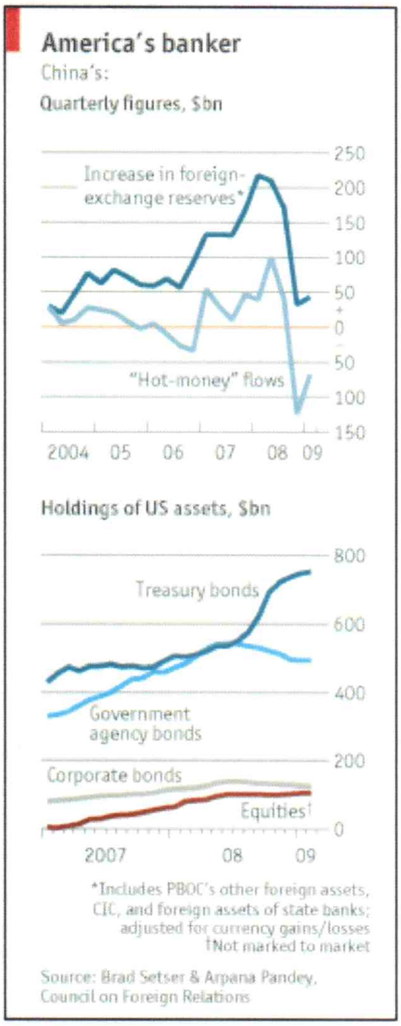
Follow the money

Assessing that risk means answering two basic questions. Is China buying fewer foreign assets? And is it diversifying away from the dollar? Few have delved deeper into the murky world of China's capital flows than Brad Setser of the Council on Foreign Relations in New York, and his analysis suggests a more complex picture than official statistics portray.

According to the official figures, China's foreign reserves are $1.95 trillion. But Mr Setser reckons that the true figure is around $2.3 trillion if hidden reserves are included, such as those of the China Investment Corporation (CIC), the country's sovereign-wealth fund, and the "other foreign assets" of the PBOC. Taking this wider measure of foreign-exchange reserves, and then adjusting for changes in the value of non-dollar reserves caused by swings in the dollar, Mr Setser reckons that China's total reserves rose by around $40 billion in the first quarter, only one-fifth of their increase in the first quarter of 2008. On the face of it, this represents a big drop in China's demand for foreign assets.

But official reserves are not the only potential source of Chinese demand for dollars. To see why, look at the country's balance of payments. China's current-account surplus is bigger than it was a year ago. That surplus along with a dollop of foreign direct investment gave China a net inflow of foreign exchange of well over $100 billion in the first quarter. If reserves rose by only $40 billion, then something else must account for the other $60 billion. Despite its strict capital controls, China is experiencing a large outflow of speculative private capital, or "hot money" (see top chart, below), largely that of Chinese investors. Just as such "hot money" inflows last year drove China's reserves up by more than the current-account surplus, so the outflows have now dampened reserve accumulation. But as long as China runs a large current-account surplus, it must, by definition be accumulating foreign assets. What seems to have changed, of late, is who is buying them. The "hot money" leaving China might still buy American Treasuries, or it could buy something else.

What of the idea that China's government has diversified into other currencies? Here, too, the statistics are hard to make sense of. The State Administration of Foreign Exchange (SAFE), which manages the country's reserves, does not disclose such details. America's Treasury reports on foreigners' investments in American securities, but these figures may understate China's stash because China buys some dollar assets though non-American intermediaries. For instance Mr Setser and his colleague, Arpana Pandy, estimate that since mid-2006, China has accounted for around 30% of purchases of American Treasuries though London. If these flows are added in to Washington's figures, China has about $1.5 trillion invested in dollar assets, of which about half are in Treasuries. This is about 70% of China's total reserves. While that is down from over 80% in 2002, the drop largely reflects the weaker dollar, not a shift into other currencies.



SAFE has spent much of the past few years diversifying the types of dollar assets it holds. During 2007 it bought government-agency debt, ie, that of Fannie Mae and Freddie Mac, rather than Treasuries. In 2007 and 2008 it started to buy equities, just before the market tumbled. In the year to June 2008, China's holdings of American shares more than tripled to $100 billion. Before the financial markets collapsed last year, SAFE may have had over 15% of its portfolio in equities and corporate bonds, which is high for an official body—and has left it with huge unrealised losses. It is widely thought that SAFE does not mark to market, so official reserve figures conceal the hit. But it is sure to dwarf the more publicised losses from CIC's investments in Blackstone, a financial firm, and Morgan Stanley, an investment bank.

By many standards China's reserve portfolio has held up well during the crisis, because most of its reserves are still in long-term bonds which rose in price as interest rates fell; and the dollar so far has been strong. But embarrassing losses on riskier assets have led to a sharp shift in behaviour. Since mid 2008 SAFE has sold government-agency debt and corporate bonds. Its purchases of Treasury bonds have surged (see bottom chart) but of late they have been almost exclusively short-term bills. According to Mr Setser's figures, over the past three months China's American assets showed no growth for the first time in many years—despite the modest increase in reserves.

What does this all add up to? China is trying to have it both ways. It wants to lessen its dollar exposure, but it also wants to hold down the yuan. The picture has been temporarily clouded by shifts in "hot capital" flows, but so long as China runs a large current-account surplus, its reserves will rise. In order to keep the yuan weak against the dollar, a large chunk of those reserves will end up in greenbacks. Beijing's appetite may not match Washington's growing need for cash. But China cannot sour on the dollar without letting its own currency rise.