

# Relocating China's Foreign Reserves

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The present global capitalism based on private property rights, free market competition and rule of law took shape shortly after World War II, which led to the first wave of contemporary international economic integration. Yet its domain at most covered half of the earth in the Cold War era since the Soviet bloc, China and a few other nations were captured by Stalinist-style command economic regimes behind Iron Curtain. In the late 1970s to the early 1980s, a new round of economic globalization regained momentum to expand the territory of the capitalism when the Thatcher-Reagan revolution rejuvenated Anglo-Saxon *laissez faire* market system and China's reforms pushed this country toward the global mainstream. No sooner than the collapse of the Berlin Wall had the modern capitalism dominated the entire world, thereby bringing about an unprecedented global division of labor.

In this context, China's phenomenal economic growth is a *de facto* triumph of the modern global capitalism. After thirty-four years of joining in the world market, China has now overtaken the United States in gross value of merchandise trading and has become the largest global trader. Thanks to steady trade surpluses together with capital controls during this period, China's official foreign reserves accrued up to \$3.3 trillion by the end of 2012, equivalent to 45 percent of the GDP. This wealth accounts for most of the Chinese external savings which are centralized, owned and managed by the government. The hoard of the massive foreign reserves gives market with strong signals to assure the value of the Chinese yuan and also acts as thick buffer to ward off external shocks. Apart from these merits, however, the vast centralized wealth poses serious problems for Beijing to deal with. Externally, China's foreign reserves, mostly parked in sovereign debt securities of the developed world, are no longer harbored in safe haven after the 2008 global financial crisis. In the unstable international monetary settings, these assets are exposed to a mix of inescapable systemic risks and intricate market risks. At home, the balance sheet of the Chinese central bank is constantly being expanded with stockpiles of foreign

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reserves over the years, and this situation was severely worsened by the recent fiscal stimulus to counteract economic slowdowns. Consequently, domestic money supply is increasing to a dangerous level and inflationary pressure mounts. In all respects, it is imperative for Beijing to decentralize a significant portion of its foreign reserves so as to address these challenges. This implies that China must begin an expedition of relocating its sizable foreign reserves and be ready to play an important role in global outbound direct investment activities.

For the past a few years the developed world has been struggling to resume growth from the global financial crisis. While the American economy has shown some encouraging signs in the recent months, Europe is still plagued by extremely high unemployment and sluggish economic performance. Among many others, lack of capital investments in industries is a main factor in preventing the West from recovering. Provided appropriate public policies and structural changes, strong investments are required for the developed economies to return to normal growing. Accordingly, it is useful for the developed world to tap outside financial sources to help revitalizing their economic activities. At the same time, it is also crucial for China to reposition its foreign reserves to reduce internal inflationary threat and diminish external risks. In short, a new strategic approach is to be needed to bridge the global demand for funds and the Chinese supply of funds. This reconciliation will have profound effects—it will not only benefit all involved countries, but will also hasten the recently-slowed pace of the economic globalization.

## **WOES OF GLOBAL CAPITALISM**

Due to the fact that markets are imperfect and individuals are short-sighted, it is reasonable for most governments worldwide to provide a diverse spectrum of social welfare services. Over years, state-funded social welfare of the developed countries on both sides of the Atlantic has proliferated rapidly and there is little difference between them with respect to government spending, tax burden and public debts. In Europe's predominant social democracy system, on the one hand, governments deliver cradle-to-grave entitlements, which claim 40 percent of the eurozone national income and push the gross sovereign debt to over 85 percent of their GDP. In America's free-market competition capitalism, on the other hand, Washington spends a quarter of the federal budget on healthcare schemes, while government sponsored enterprises (GSEs) guarantee or own most outstanding mortgages, and the government backs up the majority of new mortgages issued in the recent years. To support the enormous government expenditure, the US sovereign debt accumulates to \$15.96 trillion, about 100 percent of its GDP.

The core countries of the modern capitalism, noted by Lawrence Summers, integrate two economic sectors, a "productivity-generating market sector" and a "low-productivity state-funded social services sector". Besides, there is an accommodating financial sector which consists of three partitions to comply with the dual structure: a "market finance" to support the productive market

sector, a “state finance” to fund social welfare sector, and a “hedge finance” to engage in arbitrage and speculation against underlying assets from these sectors. Jerry Muller argued that it is the modern welfare sector which enables capitalism and democracy to coexist in relative harmony. But rapidly the growing population of social services recipients ratchet up entitlement provisions, yielding a welfare state that is too generous to be affordable for productive market sector. As a result, governments of the developed countries resort state finance method of placing public debts to shift burdens partially onto home future generations and partially onto foreign debt-security holders to prevent the welfare machine from grinding to a halt. Under the current international monetary system, the core countries are able to use their sovereign debts to “recycle” reserve currencies accrued in the peripheral countries. This procedure, in essence, rests on the rights of reserve currency suppliers to supply international exchange media without boundary and faith of reserve currency receivers on these IOUs without doubt.

In this regard, the existence of global imbalances is a prerequisite for maintaining the West’s internal imbalances. According to Rodrigo de Rato, the global imbalances are “the constellation of large (trade) deficits in one country, with counterpart (trade) surpluses being concentrated in a few others.” In the past decade trade surplus from China against the United States has been a focal issue of the global macroeconomic imbalances. Among many Asian export-oriented economies, it is the Chinese government that uses most of its foreign reserves accrued from trade surpluses to purchase the West’s sovereign debts, especially the US Treasury securities and agency bonds. Ironically, it appears to be a perfect complement between the global imbalances and the West’s internal imbalances: deficit-troubled governments at the core of the global capitalism demand for funds to sustain their welfare sector by issuing sovereign debts, while cash-rich governments at the capitalist periphery supply funds via deploying their foreign reserves on those securities.

As a matter of fact, the vow-to-cash game is based upon market trust of whether the state finances in the West are truly sustainable. Under the circumstances of the severe internal imbalances, the developed world must reform the welfare sector according to prudent and reliable governmental budget in view of a long-term horizon. However, political stalemate keeps many developed countries away from correcting the collective irresponsibility of their respective state finances and restructuring the flawed welfare state. This is largely attributed to structural deficiencies in these nations. In the United States, divergence among elites and the general populace is so extreme that it obstructs policy makers from producing rational domestic decisions, especially on issues such as federal deficit reduction, income tax adjustment, health-care restructuring, and governmental spending priorities. In continental Europe, on the other hand, the real challenge is neither the lack of fiscal union, nor political union, but rather how to deal with the policy impasse resulting from an overwhelmingly social democratic culture and the subsequent extravagance of

social services such that they overburden the future generations. The uncompromising welfare beneficiaries of the most euro-zone countries, including entitlement holders, labor unions, public sector employees and other vested interests, are firmly resisting on deep and painful but necessary reforms which Germany had undertaken a decade ago to check budget deficit and restore economic competitiveness.

While the global financial crisis wrecks havoc on the federal budget, the US political apparatus is stuck in reforming entitlement provisions. Hence, the US Federal Reserve has moved away from its long-standing independent position as the guardian of price stability and has ardently engaged in infinite quantitative easing policies (QEs) to lubricate the economy. Similarly, the European Central Bank (ECB) has also departed from its sole price stability mandate given by the Maastricht Treaty via both Long-Term Refinancing Operation (LTRO) to inject mass liquidity into the European banking system and Outright Monetary Transactions (OMTs) to buy government bonds of its member countries to cope with the sovereign debt crisis. The privileged status of the reserve currency issuers in the international monetary system enable both “global central banks” to replay a game of “our currency, but your problem” — a famous phrase pronounced by John Connally, President Nixon's Treasury Secretary, at the G-10 Rome meetings held in late 1971 to a delegation of Europeans who worried about exchange rate fluctuations as Washington devalued the dollar to preface the default of its obligations on gold conversion defined by the Bretton Woods fixed exchange rate system.

Yet, there is no panacea in the world and today's cue will be tomorrow's demise. In time, the unconventional beggar-thy-neighbor monetary policy will lead to a trust crisis of the modern capitalism. To be a dominating supplier of reserve currency or global fiat money, the US Federal Reserve must be accountable to its irrevocable obligations in all matters. To deliberately dilute unit purchasing power of the greenbacks is equivalent to stealing wealth from its creditors both at home and abroad. In sum, near-sighted actions of the major central banks plant a time-bomb for the dollar-euro-led international monetary system and are lethally detrimental to the world market. John M. Keynes (1919) warned it almost a century ago:

“Lenin is said to have declared that the best way to destroy the capitalist system was to debauch its currency.....Lenin was certainly right. There is no subtler or surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which no one man in a million is able to diagnose.”

## **PROBLEMS OF FOREIGN RESERVES**

Foreign reserves were the scarcest resource during China's entire command economy period, but the assets denominated by hard currencies have accumulated astoundingly since the 1980s. This dramatic reversal can be primarily attributed to three fundamental changes—namely, the opening-up of the Chinese economy in the late 1970s, the development of export-oriented

coastal areas from the mid-1980s, and the entry to the World Trade Organization in 2001. These strategic measures saved China from the “self-sufficient” mire and integrated the country into the world market system. As a result, the initiatives of millions of ordinary people were liberated, just as China became a major goods exporter and FDI receiver for years to generate steady inflows of reserve currencies. Moreover, China’s monetary management regime coupled with capital controls also partially accounts for the piling-up of the foreign reserves. Additionally, Beijing’s policy-makers have long been obsessed with a mercantilist view of wealth, and felt financially secure to stockpile massive amounts of globally-recognized hard currencies. Nowadays China sits on nearly one third of the world foreign reserves, while both the developed countries and other developing economies almost equally share the rest of the world foreign reserves.

But foreign reserves are by no means in synonym of “the more the merrier”. Under the current international monetary system, foreign reserves serve three basic roles: as transactional media to facilitate foreign trade, a precautionary instrument to stabilize foreign exchange markets, and a confident asset to endorse local currency issuance. According to Triffin’s reserves adequacy rule, a three-month import equivalent reserves are sufficient enough to meet a nation’s demand for exchange media. China’s reserve-to-import ratio is 7.1 times of the reserves adequacy ratio, much higher than other major global traders including Japan (5.2), Russia (4.7), Brazil (4.0), India (2.6), Korea (2.2), Singapore (1.9), Hong Kong (1.8), France (0.8), US (0.7), Germany (0.6), Canada (0.4) and the United Kingdom (0.4). After the Asian financial crisis of 1997-98, most East Asian economies considerably increased holdings of foreign reserves considerably to build up a thick buffer in case of volatility in the exchange markets. As a rule of thumb, the ratio of foreign reserves to local currency can be used to calibrate the quantity of a precaution reserves hoard. In the recent years China’s foreign reserves relative to broadly-defined money stock (M2) were 0.27-0.29, much higher than Japan’s (0.09-0.11) and close to small open economies like Hong Kong (0.24-0.36), Malaysia (0.32-0.44), and South Korea (0.32-0.45). Finally, confidence reserve demand is usually required by two kinds of economies: the one are a few city-economies like Hong Kong and Singapore, in which local monies are completely endorsed by the major international reserve currency to strengthen their status as regional financial hubs. The others are macro-unstable developing economies such as some Latin American countries in the 1980-1990s, where the dollar was used as an anchor to curb untamed hyperinflation. Measured by all standards, China’s holding of the foreign reserves is much bigger than normal needs, and it is also meaningless for the yuan issuance to be backed up by the international fiat money. Market confidence in the currency of a mega-size economy like China relies upon a healthy fiscal position in the narrow term, and stable macroeconomic performance in the broad term.

Over the past two decades the Chinese central bank, the People’s Bank of China (PBC), has vaulted most of the country’s external savings through its

conduct of monetary policy. The PBC constantly uses the yuan to buy international reserve monies, especially the US dollar, from home commodity exporters and foreign direct investors. Occasionally it sells central-bank notes to financial institutions to sterilize extra liquidity created. The monetary policy, accommodating persistent trade surpluses, led to rapid increases in the central bank assets. When its size surpassed the US Federal Reserve in 2004 and the Bank of Japan in 2006, the PBC has been the largest central bank in the world. In the Chinese central bank's balance sheet, the majority of the assets are the US Treasury bonds and European sovereign debts denominated respectively by the dollar and euro on the one hand, and its liabilities are filled with huge high-powered money in the yuan on the other hand. Furthermore, the situation became very alarming when Beijing took expansionary macroeconomic policies to boost slow-paced growth during the recent global financial crisis, thereby flooding the economy with excessive money stock. By the end of 2012, China's broadly-defined money stock (M2) recorded 97 trillion yuan (\$15.4 trillion), increasing by 50 trillion yuan (\$7.9 trillion) in the past five years. This amount is equivalent to a quarter of the global money stock, about 1.5 times of the greenbacks, and bigger than the quantity of the euro currency. Considering that China's economic size is less than half of the US economy and the yuan is mostly used for home transactions, the over-expanded central bank book ends up creating inflationary nightmare.

On a micro level, the Chinese central bank turns out to be the largest global asset management institution under the reserve-centered monetary regime, watching over vast wealth in the form of the official foreign reserves. It is estimated that approximately 65-70 percent of China's foreign reserves are parked in the dollar-denominated US debt securities, most of which are the Treasury bonds; a quarter of the foreign reserves are European sovereign debts denominated by the euro, and the rest are debts of other countries and international organizations. In addition to market risks, the foreign reserves are exposed to the global systemic risks. On top of them, the dilution of international reserve currencies, resulting from the US Fed's unlimited QEs associated with the similar ECB's actions, is wearing away the real value of the foreign reserves. In retrospect, collapse of the Bretton Woods fixed exchange rate system in the early 1970s is a good lesson to learn. After the Nixon Administration defaulted on obligations of the dollar to gold, real value of the dollar reserves held by the United Kingdom, Germany, France and Japan in terms of commodities shrank around 60 percent in the 1970s, excluding impacts of the oil embargoes occurring during this time. Looking ahead, it is projected that the unit purchasing power of China's foreign reserves against composite commodities will decline by over one third in the next few years.

For the time being, China's foreign reserves *per se* are locked in the US Treasury bonds and the European sovereign debts despite the fact that these securities are regarded as being highly liquid assets. Were large amount of the bonds disposed openly, their prices would drop sharply and devastate the market;

were the bonds placed privately, there would have little counterparties to take the long position. This is a so-called “too big to exit” problem. In addition to a possible default of US Treasury securities (though the probability is very low), the foreign reserves are faced with systemic risks caused by big uncertainty of the European monetary union. They include potential domino defaults of southern European sovereign debts, possible downsize or even meltdown of the eurozone, and the subsequent restructuring and reform of the international monetary system. All these risks may result in heavy losses to mass foreign reserve holders like China.

## **CALLING FOR CAPITAL INVESTMENTS**

Since the global financial crisis of 2008-09, the developed economies have had no resilient recovery. Recently deterioration of European economic fortunes and unsettlement of the US fiscal problem have further deterred private companies from investment and ordinary people from consumption. Compared with normal business cycles over the past sixty years, the current situation is very odd and disturbing. Among many reasons, lack of sufficient capital investments in the West is a main factor for the prolonged recession and delayed upturn. Nonetheless, there are quite a few important industrial sectors worldwide longing for capital investments, such as American infrastructures, unconventional energy industry, European banking sector, global food production and many others.

It is still controversial whether the re-modernization of the US infrastructures is necessary step in creating jobs and promoting growth in the immediate term. But the obsolete infrastructural facilities are widely-seen as roadblocks preventing the American manufacturers from improving competitiveness and households from enhancing well-being. Because the most American infrastructures are worn down or outmoded, they need billions of dollars of capital investments to be revitalized. First of all, America’s century-old electric grid network is hampered by old equipment and technologies. It is estimated that poor quality, power failures and electric blackouts lead to losses over \$100 billion annually. According to a report by the Edison Electric Institute (EEI), the American grid net needs \$1.5-2.0 trillion for constructing a reliable, smart and clean system, in which capital investments in transmission and distribution alone require \$880billion. Secondly, the US transportation system should be upgraded. The American Society of Civil Engineers (ASCE) estimates that the US road network needs \$1 trillion for rebuilding, reconstruction and improvements in the near future (a recent campaign of toll-road privatization plans to attract around \$200 billion from market investors), and the railroad network requires \$200 billion of investment for increasing capacity for both cargo and passenger transportation. In addition, the Airports Council International-North America (ACINA) forecasts that the US airports would require \$80 billion of capital investment. Thirdly, most of the US metropolitan infrastructure, including drinking-water pipes, sewage outlets,

and subway systems, are greatly in need of renewal, since such systems in New York City, Los Angeles, and many others are too old to supply quality services. Finally, American fiber-optic cable facilities and other Internet connectivity services are among the second tier group which retards growth of the information-age economy. Although the United States is the home of the ICT revolution, its average internet-connecting speed is much slower than its East Asian peers like South Korea, Japan and Hong Kong, and just ranks as number nine in the world. Indeed, both the US federal and local governments understand importance of reinvesting in these areas. Faced with budget constraints, unfortunately, the conventional Keynesian stimulus program of infrastructural spending won't work this time. Contrary to telecommunication and high-technology industries, these infrastructural areas are less politically sensitive, and there is no reason to shy away from billions of dollars of potential Chinese investment.

The world witnessed a peaceful but fundamental energy revolution in the United States—fast expansion and rapid proliferation of shale gas industry. Benefiting from clearly-defined property rights and market dynamism, the American shale gas producers have created a set of cutting-edge technologies for shale gas production, such as horizontal drilling, hydraulic fracturing, logging while drilling, geo-steering drilling, and micro-seismic monitoring in the recent years. Owing to 25-trillion-cubic-meters of recoverable shale gas reserves, the US natural gas production is expected to accelerate over next three decades and it might account for one third of its total energy provisions. Accordingly, the United States would become the largest world energy producer surpassing Saudi Arabia and Russia, and it would change from a main oil importer to be a major energy exporter. This industry has great potential because there are huge shale gas reserves available on earth to be exploited and the combustion of shale gas emits much lower carbon dioxide (CO<sub>2</sub>) and sulfur dioxide than does the combustion of coal or oil. Not surprisingly, progress of America's shale gas production is so important that it will not only significantly reshape the world energy industry to respond to climate change, but also dramatically redraw the global geo-political map to change the conflict of civilizations. Even though a few hurdles like environmental standards, regulatory structure, and gas export restriction have to be cleared, long-term capital investment is crucial to accelerate the expansion of this industry. While the gas field in Barnett of Texas is well developed, shale gas drilling in Marcellus of the Northeastern region is gaining strong momentum. It is estimated that full-fledged development of Marcellus will set up 100,000-220,000 rigs, which require \$600-1500 billion of capital investments. Taking into account fund demand in other shale gas fields including Haynesville, Eagle Ford, Woodford and Bakken along with environmental-protection solutions and distribution facilities of pipelines and liquefied natural gas (LNG), total capital investments in this sector would be as high as \$2-3 trillion in the next two decades. While the shale gas industry takes shape in the US, it is also



very promising in the other parts of the world. The globally proved reserves of shale are huge. According to the US Energy Information Administration (EIA), recoverable reserves of shale gas in 32 countries are estimated to be over 187 trillion cubic meters, about seven times larger than the global conventional natural gas reserves. Among them the top countries include China (36 trillion cubic meters), Argentina (21.9 trillion cubic meters), Mexico (19.3 trillion cubic meters), South Africa (13.7 trillion cubic meters), Canada (11 trillion cubic meters), and Australia (11.2 trillion cubic meters). It won't take long for these countries to tap their massive reserves to increase energy provisions if environmental protection issues are properly addressed.

In the recent years a spectre is again haunting Europe – this time is not the spectre of communism, but that of the home-made financial crisis originated from sovereign debt woes of the southern European countries. Although the ECB president Mario Draghi acted twice in 2011-12 to provide huge liquidity to ease market panic temporarily, the crisis is not yet over until astonishing unemployment is reduced and the eurozone economy as a whole starts growing. Since massive sovereign debts of the southern European countries are held by major European banks, the former's mess contaminates the latter's balance; and subsequent banking distress, in turn, devastates the European real economic sectors. This vicious cycle endangers the entirety of Europe, as well as the euro. No one knows the exact losses of the southern European sovereign debts, or the bad assets of the European banks. In consequence, the European banks must raise more capital, not only to meet BASEL III requirements for sheltering them from resurgence of the financial crisis and economic downturn, but also to be able to carry on normal lending for spurring the European economies from lengthened recessions. It is estimated that the European banks need around €600 billion for recapitalization, and this amount would go up much higher if the European economy worsened. Thanks to fatal flaws of the monetary union, i.e., no regular fiscal transfers and consolidated federal power, the eurozone governments, behaving like seventeen legally identical oligarchies in a market, can hardly initiate functional tools such as the Eurobond or a “European TARP” to recapitalize the distressed banking system. On the other hand, the European banks are in the course of deleveraging balances and spinning off non-core assets and troubled loans. The IMF estimates that the size of the European banking system may shrink by \$2.6 trillion in next few years, which is about 7 percent of the total assets. Recently PwC, a market consultancy, predicted that the European banks will deleverage €3.4 trillion from their balance sheets to make themselves viable over the coming years. Regardless of which estimated figure proves to be more accurate, there will be a big contraction of bank lending in Europe. According to Prime Collateralized Securities, at least €4 trillion will be needed to fill the hole caused by the banks' withdrawal. This trend will have very negative impacts on small and medium-sized firms, which consist of most European companies and create over 70 percent of jobs. Indeed, an external funding source is needed for Europe to relieve the burden from its

troubled banking sector.

One of the long-term challenges the world faces is how to feed its rapidly expanding population. During the period from 1999 to 2011 the world population has increased from 6 billion to 7 billion and it is projected to reach 8 billion in 2025 and 9 billion in 2045. The United Nation's Food and Agriculture Organization (UNFAO) pointed out that the world population growth and an increasing middle class in the developing world are the main factors of boosting demand for grain-intensive protein. On the other hand, the world production of cereal foods including maize, rice and wheat has stagnated at around 2.2-2.3 billion tonnes in the past five years. Thus, the world food stock-to-use ratio has declined from 25 percent in 2002-03 to 20.5 percent in 2012-13, indicating that a potential gap between the world food supply and demand has enlarged. Moreover, a new study led by Deepak Ray of the University of Minnesota published in *Nature* indicates that after decades of fast growing global agricultural output, production of four of the world's most important crops—maize, rice, wheat and soybean—could be stagnating or even slowing in some regions, which may account for about a quarter to a third of global production of these crops. Largely due to last summer's heat and drought in the US, Russia and Europe, food prices have been rising steadily around the world in recent months. This is an alert for the world food provisions. The UNFAO, holding a meeting on the world food security in Rome last October, warned that 870 million people around the world—or one in eight—are starving or undernourished. Food security is also a serious challenge to China. While the rapid urbanization competes with food production for land, China's arable land is only about 9 percent of the world total, lower than those of India (11 percent) and US (12 percent). According to the National Statistical Bureau of China, the food production recorded 589.57 million tonnes in 2012, of which cereal foods was 532.99 million tonnes. From January to October of 2012, China imported 60.88 million tonnes of food, over 10 percent of the total food consumption. This makes China a big buyer in the world food market, purchasing about half of the global soybean export.

A practical solution is to increase provisions of the food supply worldwide. Indeed, land-abundant countries have high potential to increase their capacity of food production. Over the past decade investors around the world have leased enormous land for farming in Africa, Asia and Latin America. But these commercial activities create two serious concerns that must be addressed for sustainable enlargement of agricultural production in these regions. The first is how to preserve rights of local residents and their offspring to benefit from commercial farming activities. In many areas ordinary people's rights for communal land are ignored—local leaders and authorities sell or lease the land without proper consultation or adequate compensation to local residents. The second is how to protect environments to avoid predatory development and ecological disasters. To serve the long-term interests of these countries, a new model of inclusive farming development based on equal participation and

mutual benefits of all involved parties should be formulated. This development also requires billions of investments in irrigation systems, logistic networks, storage facilities, environmental protection schemes, agricultural financing, and community services to promote steady growth of the global food production as well as to secure local people's long-term interests.

## **REDEPLOYING EXTERNAL SAVINGS**

China's mass foreign reserves could be tapped to meet global investment demand in real economic sectors to enhance productivity generating process. Under the circumstance of the global liquidity glut, it is a matter of great urgency for Beijing to divert its assets denominated by hard currencies. To avoid huge losses, a significant portion of the nationalized external savings needs to be decentralized and privatized; rigid mandates of reserve assets enforced by governmental agencies should be replaced by adaptive management exercised by commercial entities; and holdings of vast sovereign debt securities should be diversified to include equity claims against private corporations in commercial industries to create values. This action will render twofold benefits, the one is to reduce risks that China faces, and the other is to facilitate future growth of the world economy.

Providing reforms to adjust monetary policy conduct and lift capital controls, a well-designed financial facility is vital in the procedures of relocating foreign reserves. A structural vehicle called as debt-equity swap (DES) is an appropriate option to serve this end. Conceptually, it is a special instrument of asset conversion that alters debt requests into equity claims in the process of liability restructuring so as to reduce unbearable obligations or to minimize losses. To date there exist diverse types of debt-equity swaps, such as Brandy bonds used to address the Latin American debt crisis in the 1980s, Resolution Trust Corporation (RTC) to solve the US S&Ls crisis in 1989-95, Bridge banking model of Japan and South Korea to tackle bad loan problems in the late 1990s, and Asset Management Companies (AMC) to work out the Chinese state banks' non-performing loans in the early 2000s. Furthermore, a variety of asset conversions are also being employed to deal with the liquidity pinch in the current financial crisis. One example is that last year the Italian government traded state properties with commercial banks for its sovereign debts, and then it leased back the properties from the banks; the latter, in turn, transformed these properties into asset-backed securities (ABSs) that were used as collateral to borrow money from the ECB. Another example is the Temporary US Dollar Swap Arrangement between the US Fed and the ECB for swapping dollars with euro in the recent years, for the purpose of quietly extending loans denominated by dollars to the European banks.

To date all existing debt-equity swaps are *ex post* instruments designed to address problems of debt defaults and/or compensation during liquidation process. The problem of "our money (bond), your problem" must be tackled before the situation gets worse. In this regard, *ex ante* debt-equity swaps can be

created to redeploy a significant portion of the foreign reserves in real business sectors. This special facility includes three steps to execute the asset conversion. First, the Chinese central bank trades the US Treasury bonds with investment entities for the yuan. Second, the investors swap the Treasury bonds to equity shares or equivalent claims of targeted companies, or commit them in green-field projects in foreign countries. Third, the bond-receivers take the US Treasury bonds as collateral to obtain bank credits or issue asset-backed securities for liquidities. The success of the *ex ante* DES facility rests on availability of a variety of market-oriented and highly-professional investment platforms. As such, it is needed to set up new private investment companies that are featured by mixed joint-share ownership, sound corporate governance structure and adaptability to external environments. Moreover, China's state investment monopolies like the SAFE Investment Company affiliated with the State Administration of Foreign Exchange (SAFE) and the China Investment Corporation (CIC) should be also reshaped to excel in market competition. Among many ways of restructuring government's hierarchical investment arms, Sweden's AP-fonden model to partition the Swedish National Pension Insurance Funds into a few independent and competing funds is worth to learn.

To effectively contain the pending risks for protecting foreign reserves' value from losses as well as to enhance real return of external savings for coping with China's aging population problem, Beijing needs to convert around \$1.5-2.0 trillion of the foreign reserves parked in sovereign debt securities into private equity-related claims. Notwithstanding the fact that the would-be asset swap is huge in size, China has enough domestic financial sources to retire significant portion of the foreign reserves. The main source available to be utilized is the bank deposits denominated by home currency. Recently the Chinese yuan deposits with commercial banks total an equivalent of \$12 trillion, about twice of the GDP. Thanks to wide financial controls, ordinary Chinese people have little investment choice other than to passively take low-interest bank deposits. The DES facility, thereafter, will provide a channel for the Chinese people to enlarge their portfolios and enhance returns of the wealth. In addition, the Chinese insurance companies, the National Social Security Fund and the municipal social security bureaus, manage enormous funds equal to around \$3 trillion, which are ready to be disposed partly in long-term assets with steady cash-flows.

Yet, there have many internal and external obstacles that keep China away from relocating its foreign reserves to global capital-hungry industries. Domestically, there are two main concerns that prevent the authorities from even partially privatizing the foreign reserves and releasing the capital controls. The first is worry about the avalanche of huge capital outflows caused by widespread corruption activities, which may lead to disastrous economic and social consequences. The second is fear of possible currency attacks from global hedgers and speculators, which may paralyze the fragile financial system. Indeed, the capital controls cannot check illegal wealth outflows resulting from

corruption but good public governance based on transparency, accountability and rule of laws can. On the other hand, potential speculative attacks can be fenced off when relaxation of the capital controls is taken at a progressive and reversible pace, necessary restrictions on short-selling and margin trading of financial assets denominated by local currency are imposed, sound firewalls between different financial institutions are installed, and a comprehensive safeguard system is created.

Some destination countries may fret over large-scaled investment pouring in from China. To relieve worries of “buying up hosts”, the Chinese investors must learn how to operate and get used to host countries’ environment to embark on outbound investment activities. They may take minority equity shares in invested companies, or accept equity securities with convertible features, buy-back clauses and other initial share-holding options. They may also carry out investments in passive manner and take non-managerial roles through bridging vehicles such as private equity funds, overseas industrial funds, fund of funds and many others. Besides, they may pursue green-field projects that are faced with less resistance. There are many ways of conducting green-field developments such as build-operate-transfer (BOT), rehabilitate-operate-transfer (ROT), design-build-finance-operate (DBFO), and build-lease-transfer (BLT). Ownership structure of the Chinese investors should be diversified. In particular, private investment firms should be encouraged to participate in debt-equity-swaps, and all investors need to increase operational transparency and release accurate information to enhance reliability. In addition, the Chinese may form partnership with other global institutional investors to jointly engage in businesses to reduce concerns of host countries.

Compared to other destinations, China’s direct investments in the American businesses lag far behind the huge bilateral trade between the two largest world economies even though the Chinese investors are very keen on exploring the US market. For example, China’s accumulated direct investments in the US soil were \$4.8 billion by the end of 2010, merely accounting for 1.5 percent of the total. Indeed, there are many roadblocks that deter the Chinese investments in the US territory. On the one hand, the Chinese investors have to face an unfamiliar but much more binding legal and regulatory environment of rules and laws in taxes, employment, environment and intellectual property rights. This may cause operational risks for the Chinese investors. On the other hand, investments from China, especially from state-owned enterprises and a few big private firms, are alleged as “potential Trojan horses”—an over-exaggerated suspicion similar to the Chinese ideological jargon of “bourgeoisie’s sugar-coated shell” used in Mao’s era implying money and beauty used by adversaries to lure revolutionary cadres and “bourgeoisie’s spiritual pollution” in the early 1980s referring to influence of the western culture. Hence, the Chinese investors may be confronted with political risks largely caused by tilted attitudes from Washington. Responding to these challenges, the Chinese investors should be proactive in engaging the federal and local governments,

legislature, media, labor unions and the general public in the US. To work closely with host service providers such as law firms, accounting companies and public relation consultants would be helpful for them to navigate in uncharted waters. On top of these, a strategic breakthrough between Beijing and Washington should be reached to deepen and widen the long-term Sino-US relationship in various facets, including creative solutions to enhance investments from China.

## **VALUE CREATING DEAL**

The West should take three key measures to overhaul the modern capitalism. The first is to put forward cost-sharing schemes among stakeholders to buy time for fixing structural defects. The second is to rebalance the state-financed welfare sector to save overstretched budgets. The third is to promote long-term growth to revitalize distressed economies. Among them the cost-sharing plan is the easiest one to be pursued. Indeed, the procedure had been executed when the US Fed and the ECB engaged in unbound money printing to shift burden on all holders of their IOUs domestically and worldwide, Germany bailed out the southern European countries regionally, and western governments raised taxes on affluent households at home. However, internal rebalancing of welfare state is lagging, because politically it is very difficult at present for most developed countries to take painful and controversial reforms on public spending, entitlement provisions and the labor market. Alberto Alesina and Silvia Ardagna, in their recent *NBER* paper studying of 21 OECD countries over the past forty years, concluded that “(government) expenditure based adjustments (spending cut) are more likely to lead to a permanent reduction in the debt over GDP ratio. In addition, they are associated with smaller recessions than tax based ones (tax increases) or no recessions at all. The component of private demand which seem to react more positively to an expenditure based adjustment is private investment... Certain combinations of policies have made it possible for spending based fiscal adjustments to be associated with growth in the economy even on impact rather than with a recession.” Although this policy is proved a feasible way out of the crisis, there will be a long and intricate political wrestling before policy makers reach a consensus. If the developed countries failed to undertake internal rebalances, the cost-sharing process will be nothing but an abyss of “redistributionist economics” branded by Robert Barro, a slippery slope to perdition for the modern capitalism.

Whilst the above two steps are featured as necessary conditions, strong economic growth is by itself a sufficient condition of upholding the world market system. Needless to say, dynamic capital investment in real economic sectors is a main driver in pushing the global economy back to a normal track. But the recent economic disasters together with political paralysis and psychological pessimism halt the developed countries to commit long-term investment. In the United States, both of the federal and local governments are under fiscal pinches. As long as entitlement provisions, especially Medicare

expenditure, continue to worsen the heavily-indebted budgets, the government will not have the financial resources to renovate rusty infrastructures. In the meantime, private companies, still caught in the post-crisis gloom, either hoard cash deeply or repurchase their own shares when they have extra money. Accordingly, foreign direct investments, including those from China, will partly fill the void left by both public and private sectors in American economy. Needless to say, thousands of gravely needed job opportunities in the West will emerge as long as vast foreign investment flows in real sectors. The current Sino-US bilateral trade has provided around 800,000 jobs for American workers, and it is expected that similar job slots would be created if the US market absorbed a-trillion-size capital investment from China.

Capital investment from China is particularly useful to upgrade quality of infrastructures, speed up development of unconventional natural gas industry, and revive manufacturing sectors in the United States. In retrospect, the American infrastructural sector has a history of tapping foreign funds to facilitate its development. In the late 19th century, for example, over 20 percent of American railroad construction was financed by foreigners. Moreover, opening-up of the US shale gas industry for foreign investment will accelerate the US energy independence and also help the American firms use their advanced technology to exploit the huge Chinese shale gas reserves with the inclusion of reciprocal clauses. Recently there are a few encouraging investments in this area from China, for example, during 2010-2011 China's Cnooc corp. bought stakes in Chesapeake Energy's shale fields in Texas, Colorado and Wyoming; and in 2012 China's Sinopec corp. set up joint venture with Devon Energy corp. to drill oil and gas in the US Midwest. In every respect, it is uneconomical to turn away investments from China and investment protectionism will only impede the US economy. In Europe, the situation is even worse, where the ailing banking system is contracting and widespread fears halt local companies from investing. But the economy won't resume normal growth to alleviate unduly high unemployment unless bank lending to small and medium enterprises resurge and investments in industries start growing.

To be a largest beneficiary of the world market system over the past three decades, it is in China's own interests to help preserve it. While the global industries longs for long-term investment, China will also need to redeploy its foreign reserves to contain negativities of the international monetary system and to enhance returns of external savings to cope with its aging population. To bridge the global capital demand and the Chinese financial source, the proposed *ex ante* DES facility will benefit all involved parties. On the one hand, it is an appropriate way for China to tackle implicit value depletion of the reserve currencies and other systemic risks. The method will also call in significant high-powered money to rewind the PBC's amplified balance sheet for the purpose of reducing inflationary pressure and safeguarding the wealth of the ordinary Chinese citizens. On the other hand, this procedure will provide outside sources to promote real investments in the developed countries and refresh the

global economy. Finally, this facility will steer clear away from a catch-22 problem in the world financial market, i.e. a mass selling of the US Treasury bonds will cause excessive market volatility and a sharp rise of interest rates, but a perpetual holding of these debt securities will yield heavy losses for the owners.

The importance is not merely economical. Against a backdrop of increasing misreading and distrust between Beijing and Washington in the recent years, there prevails an atmosphere impeding enrichment of the bilateral relationship between them. To promote global prosperity and regional stability, current pointless tensions caused largely by Obama's incoherent policy of "pivot to Asia" and subsequent backlash of the Chinese nationalism must be rewound and the long-standing path of deepening Sino-US cooperation needs to be resumed. Joseph Nye correctly pointed out that "(China) is not seeking global hegemony, and the United States not only has an immense trade with China but also huge exchanges of students and tourists.....If we treated China as an enemy, we were guaranteeing a future enemy. If we treated China as a friend, we kept open the possibility of a more peaceful future." Both China and America, instead of confrontation, must discover innovative ways to strengthen long-term cooperation and maintain trustworthy relationship with each other to secure a better future for the world. While the huge bilateral trade and close social contacts make up two important pillars of the mutually dependent relationship, strong business investments will definitely add a third pillar to reinforce the tie between them. It is a high time for the new Chinese cabinet and the second-termed Obama administration to reach a breakthrough consensus to serve this end. Recently John Miligan-Whyte, Dai Min and Thomas Barnett of the Center for America China Partnership outlined a comprehensive proposal for recasting the most complicated bilateral relationship. Along with other important clauses regarding security and strategic subjects, they suggested that China should pledge to invest up to \$1 trillion directly in US companies. It is a vital and forward-looking suggestion, but questions such as where funds come from and how to invest should also be answered. Actually, partial decentralization of China's massive foreign reserves will provide sufficient fund sources and DES facility will be an appropriate approach of deploying Chinese investments in the American real economic sectors. This vital issue should be listed on the agenda of annual Sino-US Strategic & Economic Dialogue (S&ED) for drawing an applicable roadmap. Other than previously-tossed stereotypical topics, converting part of the US sovereign debt securities held by the Chinese government to equity-like investments in America's private sector is a real value-creating deal. This will benefit both sides. A well-designed DES facility will not only greatly reduce worries about implicit depreciation for the dollar-denominated foreign reserves, but also directly promote capital investments in industries which are crucial to restart the dynamics of the American economy. Moreover, this deal will beef up common interests of both sides so as to stabilize long-term Sino-US relationship.



The plain fact of the current *status quo* is that the West is using money printing to lessen domestic agonies whilst sturdy populist pressures prevent reforms of welfare statism. To a large extent, this is a world redistributive game played in line with asymmetric rules of the international monetary system. Although it surely transfers costs to debt holders, this method jeopardizes the economic dynamism of the modern capitalism and wrecks market trust in it. In these circumstances, it is high time for China and other reserve-rich countries to contain losses from the zero-sum game and to make value creating actions by relocating their inertly-parked foreign reserves. In this regard, China may lead export-oriented economies and petroleum-supplying countries to diversify their endangered wealth. This move will facilitate the global rebalances—not only to narrow down trade imbalances among major nations, but also reallocate financial resources between state and market sectors worldwide. Contrary to most investors with limited time horizon, investment funds converted from foreign reserves are particularly suitable to finance long-term investments in real economy. If one third of the global foreign reserves were spun off to this end, the landscape of the global finance would be significantly changed and sufficient resources could be mobilized to improve infrastructures and augment productivity-generating market sectors. This trend will, therefore, lay down a solid foundation for a new round of the robust world growth.