

ASIAN WEEKLY ECONOMIC INSIGHTS



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Asian Economic Perspectives

Stumbling Markets Look to China's FX Reserves with Hope and Fear

Will China come to the aid of tumbling global asset markets by restoring a measure of stability through an injection of liquidity from its US\$1.3 trillion of foreign exchange reserves?

Or will it make matters worse by liquidating part of its US\$407.4 billion holding of US Treasuries, as it is said to have threatened to do in retaliation against growing anti-China sentiment in US Congress?

The fact that these questions have arisen after yet another week of market turmoil demonstrates two things: a perception that the financial shocks caused by the deterioration in US subprime home loans are not easing and may even intensify; and recognition of China's emergence as a global financial power. World factory today, world banker tomorrow?

Liquidity injections by the US Federal Reserve and the European Central Bank have yet to calm volatility and markets expect more coordinated intervention by developed-country central banks if the crisis continues. China, as holder of the world's largest pool of foreign exchange reserves, is potentially a major source of liquidity. Optimists see the crisis as an opportunity for the country. As well as earning political goodwill—and thereby potentially easing the threat of a protectionist backlash—market intervention by the People's Bank of China (PBOC) could strengthen China's leadership credentials and allow it to make a profit into the bargain.

Will China Take the Lead...

Buying, at a suitable discount, distressed assets in the US subprime markets may turn out to be highly profitable and would certainly be in keeping with the mandate of the country's proposed sovereign wealth fund, likely to be known as the China Investment Corporation (CIC). Moreover, by

making a gesture of goodwill to the US under such circumstances, Beijing would almost certainly accumulate political capital on Capitol Hill—perhaps enough to water down some of the anti-China trade legislation being formulated in Congress.

These are the theories—and, perhaps, the wishful thinking—of those who see PBOC intervention as a possibility. In our view, however, the chances of China taking such an initiative are slim. We think that, while the country is keen to be a leader in Asia and among developing countries generally, it remains reluctant to assume such a role in the developed world. The reason for this is that Beijing still sees China as a low-income country that cannot bear such a responsibility.

...Or Twist the Knife?

Pessimists see China's political posturing—recently said to include a threat to liquidate US dollar assets in response to escalating anti-China sentiment in Congress—as potentially exacerbating market volatility. We do not regard this alleged threat in itself as realistic, however. US dollar investment assets comprise nearly half of China's FX reserves: Significant liquidation would hurt world markets and reduce the value of US dollar assets left on PBOC's books. Small-scale liquidation may be feasible. It then becomes a question of size.

Admittedly, PBOC will need US\$200 billion later this year as start-up funding for CIC. Part of this amount, however, could be financed by a simple transfer of ownership of assets from the State Administration of Foreign Exchange (SAFE) to CIC. This method was used by PBOC in 2003 and 2004 when shoring up the capital adequacy ratios of three state banks; the amount involved was \$US65 million. Part of the initial CIC funding may also come from hard-currency cash accruing to

PBOC from a recent unwinding of its FX swap positions with domestic commercial banks.

US\$ Assets Shrink as Share of FX Reserves

An understanding of how China currently manages its US dollar assets may help to answer the question. Data compiled by the US Treasury Department describes what appears at first sight to be a worrying trend. China was a net seller of US Treasuries in both April and May (the latest data available), disposing of about US\$12.5 billion (**Display 1**). This, however, accounted for only about 3% of China's total holdings. In April, the selling took place mainly at the short-end of the curve (about US\$4.9 billion); in May, it consisted more or less equally of short- and long-term bonds (about US\$3.3 billion each). As a result, China's total holding of US Treasuries dropped to US\$407.4 billion, equivalent to 31.5% of total FX reserves. The ratio has declined from around 45% in 2000. In that year, China spent 50 US cents of every US\$1 increase in FX reserves on US Treasuries. This year, it is spending just 10 US cents.

The country has, however, increased its stake in other US dollar assets, most noticeably corporate and agency bonds (**Display 2**). Overall, total holdings of US dollar assets amounted to US\$634 billion in May, nearly twice the amount for June 2004. The proportion of US dollar assets to total FX reserves has fallen, however: though still large at 49.1%, it is well below the 72.4% of three years ago. China has already effectively diversified away

from US dollar assets by progressively buying fewer relative to each incremental increase in reserves.

A related question, which is difficult to answer, is whether the transfer of FX reserves to CIC from SAFE will involve an immediate sell-down of US dollar securities. We have presented our views on this previously (*Asian Weekly Economic Insights*, 'China's New Investment Fund Reshapes the Policy Landscape,' July 6, 2007). We repeat some of the main points below.

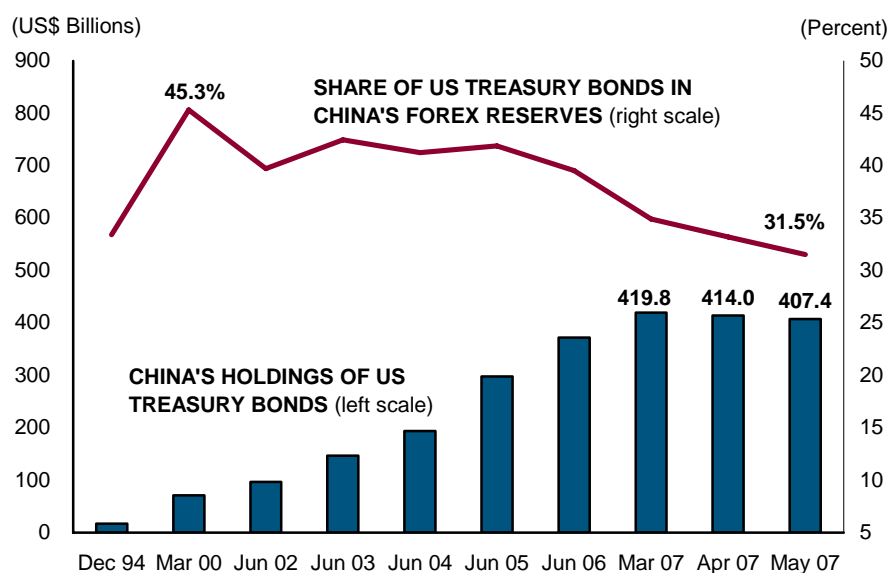
First, the US\$200 billion assigned to CIC could consist of US Treasuries as well as cash. We suspect that about US\$50 billion–US\$60 billion will come from the unwinding of the central bank's FX swap positions.

Second, if we assume that one-third of the remaining US\$140 billion–US\$150 billion were to consist of securities currently held in the US portfolio, then, potentially, CIC would need to liquidate about US\$50 billion (or 12% of the total) of US Treasuries. In terms of the impact this would have on bond markets, timing would be the key issue. We suspect that CIC would be in no hurry to liquidate its holding, as it would need time to fully invest the initial capital.

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Display 1: US Treasuries Fall as Share of China's Total Forex Reserves

China Holdings of US Treasury Bonds



Source: US Treasury, CEIC Data and AllianceBernstein Fixed Income estimates

Display 2: China Is Still Buyer of Other US\$ Assets

China Holdings of US\$ Assets

		Total	Equities	Long-Term Treasuries	Long-Term Agencies	Long-Term Corporates
Asset Stock (US\$ Billions)	2004 Jun	\$341.0	\$2.5	\$189.2	\$114.9	\$16.2
	2005 Dec	462.2	1.9	242.6	148.5	51.1
	2006 Dec	569.0	2.5	283.2	182.9	82.2
	2007 Jan	583.9	2.4	283.4	194.3	85.6
	Feb	600.1	2.4	293.1	196.8	89.7
	Mar	612.2	2.3	296.8	202.5	92.4
	Apr	624.0	2.3	295.8	211.5	96.2
	May	634.1	2.2	292.6	221.3	99.8
Share of Total China Forex Reserves	2004 Jun	72.4%	0.5%	40.2%	24.4%	3.4%
	2005 Dec	56.4	0.2	29.6	18.1	6.2
	2006 Dec	53.4	0.2	26.6	17.1	7.7
	2007 Jan	52.9	0.2	25.7	17.6	7.8
	Feb	51.8	0.2	25.3	17.1	7.7
	Mar	50.9	0.2	24.7	16.8	7.7
	Apr	50.1	0.2	23.7	17.0	7.7
	May	49.1	0.2	22.6	17.1	7.7

Source: US Treasury, CEIC Data and AllianceBernstein estimates