Foreign Exchange Investment Corporation

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The Chinese government established the State Foreign Exchange Investment Corporation (SFEIC) recently in an effort to make use of its swollen foreign exchange reserves more efficiently and profitably.

China had accumulated as much as $1,333 billion in foreign exchange reserves at the end of last July. Generally speaking, there are two reasons for accumulating foreign exchange reserves. The first is to enable the government to pay the cost of imports in foreign currency. For this purpose, it is said that foreign exchange reserves would be enough if they can pay the costs of three months' imports. China's imports last year were around $66 billion per month, which means three months' imports cost $198 billion. The second reason is to be ready for possible flight of short-term foreign debts out of the country. Even when foreign debts are pulled out all at once from a country, the country's government would have no problem if it possessed more foreign exchange reserves than the balance of short-term foreign debts. In the case of China, the balance of short-term foreign debts at the end of 2005 was $156 billion. If prudent, the government of China should possess that much, in addition to the amount to pay the costs of three months' imports. This means that the Chinese government should hold $198 billion plus $156 billion, which makes around $350 billion.

Therefore, out of the $1,333 billion in foreign exchange reserves, around $1 trillion ($1,333 billion minus $350 billion = $983 billion, or approximately $1 trillion) can be deemed excessive in China.

There are at least three problems with excessive foreign exchange reserves.

Firstly, the excessive part of foreign exchange reserves, being used mostly to purchase US Treasury bonds with low interest rates, does not earn enough profit. In addition, it has not been used for more meaningful purposes such as contributing to develop Asian bond or stock markets.

Secondly, it will bring about excessive liquidity in the financial market of the country concerned.

Thirdly, to keep excessive foreign exchange reserves is risky due to possible falls in the US dollar, which constitutes most foreign exchange reserves in many countries.

I think SFEIC was established to try to solve these three problems.

The mechanism of SFEIC is a little bit complex.

Firstly, the Ministry of Finance of China (MOFC) issued as much as 600 billion yuan ($77.4 billion) in special national bonds. All these bonds were purchased through the market by the People's Bank of China, the central bank, which paid the dollar equivalent of 600 billion yuan out of foreign exchange reserves. MOFC acquired dollars in exchange for special national bonds and is supposed to invest overseas through SFEIC in foreign government bonds, foreign corporate bonds and stocks, and energy and other primary resources with an intention to improve the profitability of official reserves. SFEIC seems to be allowed also to carry out foreign direct investments per se. On the other hand, the People's Bank of China will try to absorb excessive liquidity in the country's financial market by selling special national bonds it acquired in exchange for reducing foreign exchange reserves.

However, there are fundamental questions with the new organization. The first question is whether a government is allowed to invest in risky securities or programs. The original source of foreign exchange reserves is tax or debt of the government or central bank. Would it be appropriate for such money to be exposed to high risk, even though it be more profitable?

The second question is whether governmental officials can find profitable opportunities for direct or indirect investments. If the answer is yes, then why don't they invest through channels other than SFEIC as well? Of course, MOFC can hire experts from private companies, but then why does it not ask such private companies to do this job instead of establishing SFEIC?

The third question is whether SFEIC will intervene in the management of invested companies. If that is the case, is it not an intervention by a state-owned corporation (SOC) that has been criticized as inefficient after the collapse of the old communist regime in Europe, including Russia? In China also many SOCs have been replaced by private companies. SOCs should not be allowed to reemerge in the form of SFEIC.

Lastly, since the government is involved in the creation and operation of SFEIC, how much transparency it can ensure is a big question.

As is written above, there are many questions regarding SFEIC. China is not alone in establishing an organization seeking to manage government-controlled money more profitably. Singapore has Temasek, and the governments of some Middle East countries and other oil-rich countries have already established investment funds or are going to do so in the near future. They are called sovereign wealth funds. I strongly hope these questions will be taken into consideration before establishing such funds or during their operations. JS

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