

# Management of China's International Reserves: China and a SWF Scoreboard

Conference on China's Exchange Rate Policy

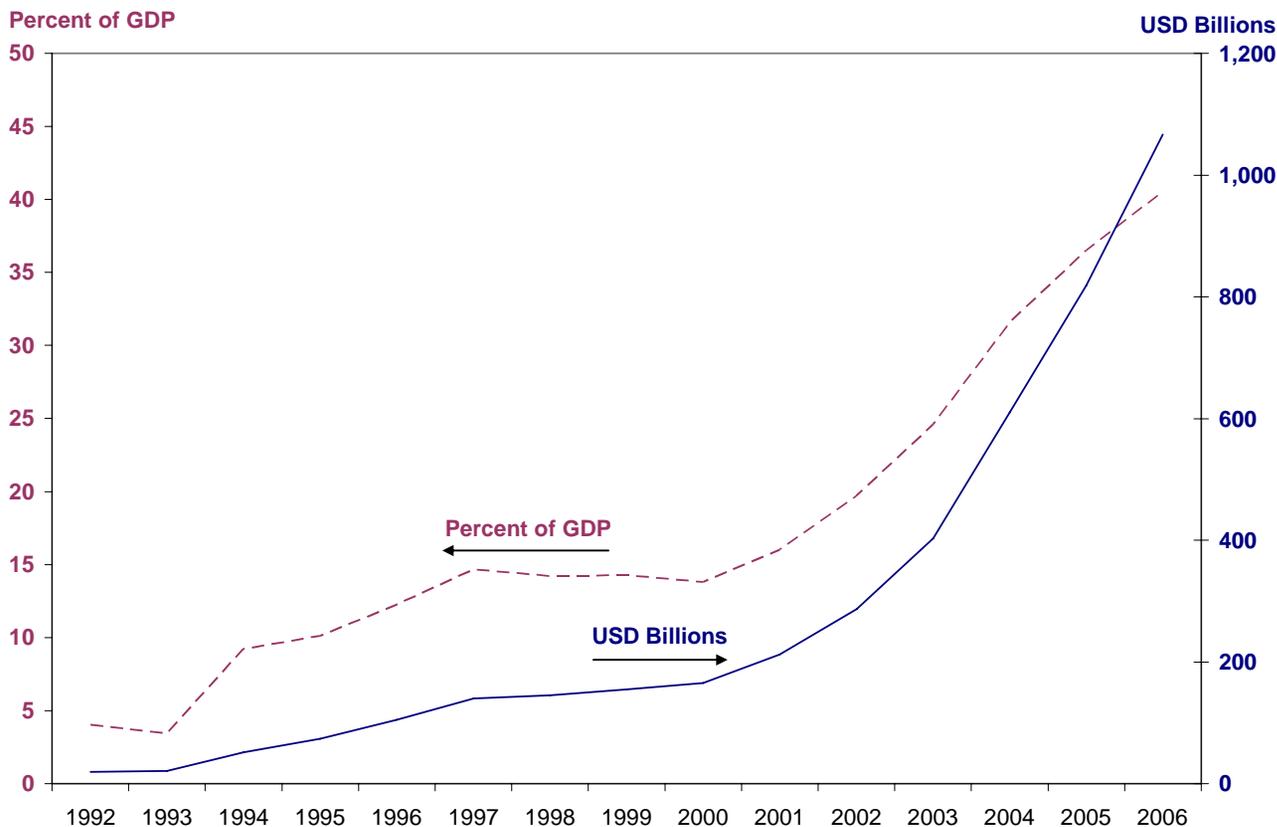
October 19, 2007

Edwin M. Truman with Doug Dowson

# Introduction & Summary

1. China has a **\$1.5 trillion problem** managing its huge and growing stock of international reserves
2. How well the Chinese authorities deal with this problem has **profound implications** for China as well as for the international financial system
3. To date, the Chinese authorities have done poorly; its previous SWF (Central Huijin) scores **substantially below the average** on our scoreboard for SWF
4. The Chinese authorities should adhere to a higher standard for the new CIC
5. They also should play a leadership role in establishing a global set of best practices for SWF

# The Growth of China's Reserves



- China's foreign exchange reserves have expanded rapidly for 15 years, in particular since 2000
- Reserves are substantially in excess of China's medium-term needs
- China's has become the world's largest manager of cross-border assets

# Four Possible Approaches

1. China can substantially **modify its exchange rate policy** and limit the further accumulation of reserves, but the reserve management challenges would remain
2. China can seek to use its reserves to **promote domestic development**, but this is problematic with respect to monetary, fiscal, risk management policies
3. China can use its reserves to achieve **external economic or political objectives**, which raises a host of issues
4. China can seek to **maximize the return** on its reserves, investing them wisely in an array of external assets, but even here China face problems

# Issues for China's New CIC

1. Motivated by political or economic power considerations – actual or perceived
2. Backlash of financial protectionism
3. Financial market uncertainty and turmoil
4. Conflicts of interest for managers and intermediaries
5. Domestic economic and political challenges

# Answers for China

Many of the concerns about the CIC and its management of China's external investments at this point are **hypothetical**

However, the world will hold China to a high, if as yet undefined, standard of **accountability**

What are the likely **elements** of such a standard?

# A Scoreboard for SWF

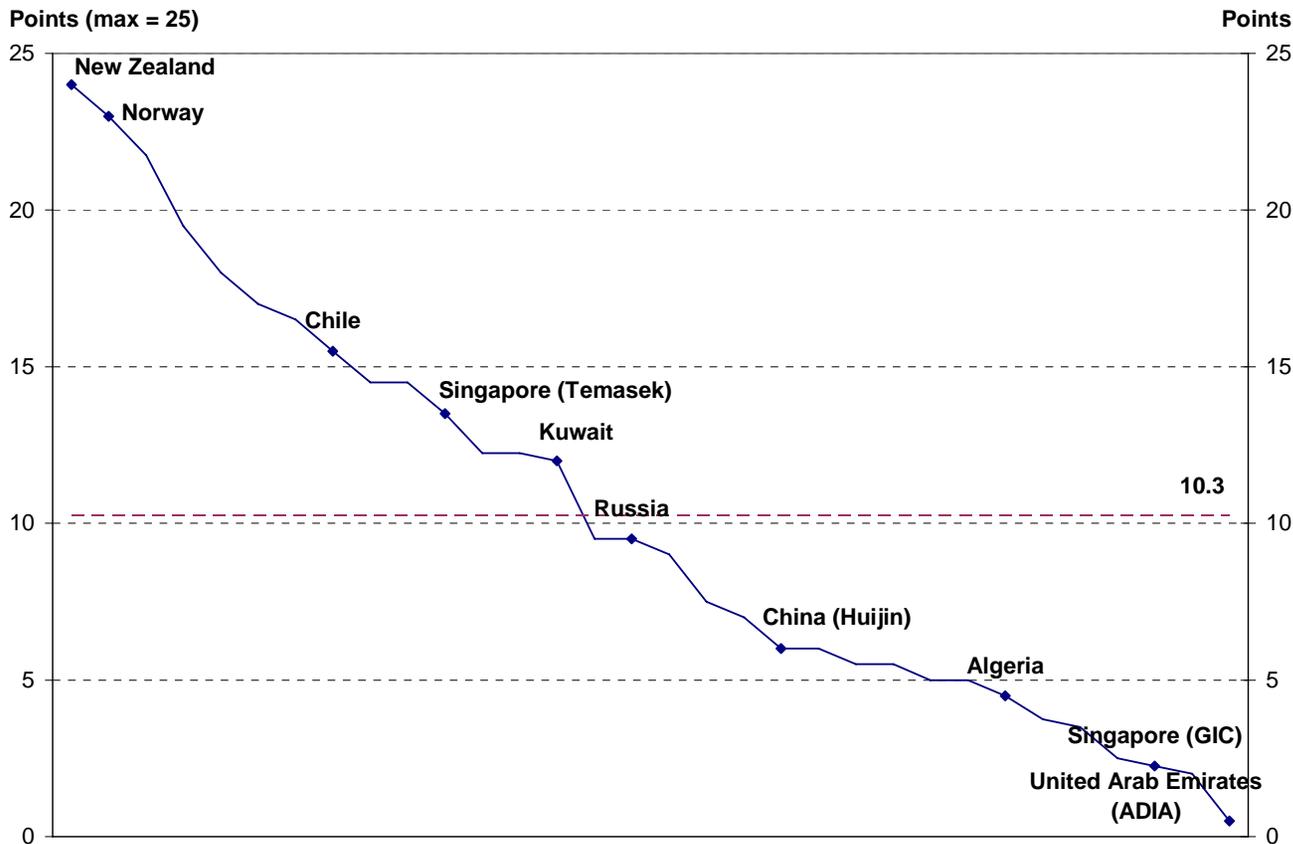
A set of best practices for the CIC and other SWF should include four basic components:

1. **Structure**
2. **Governance**
3. **Accountability and transparency**
4. **Behavioral guidelines**

We have designed an illustrative set of best practices and scored **32 SWF of 28 countries**, including China's Central Huijin

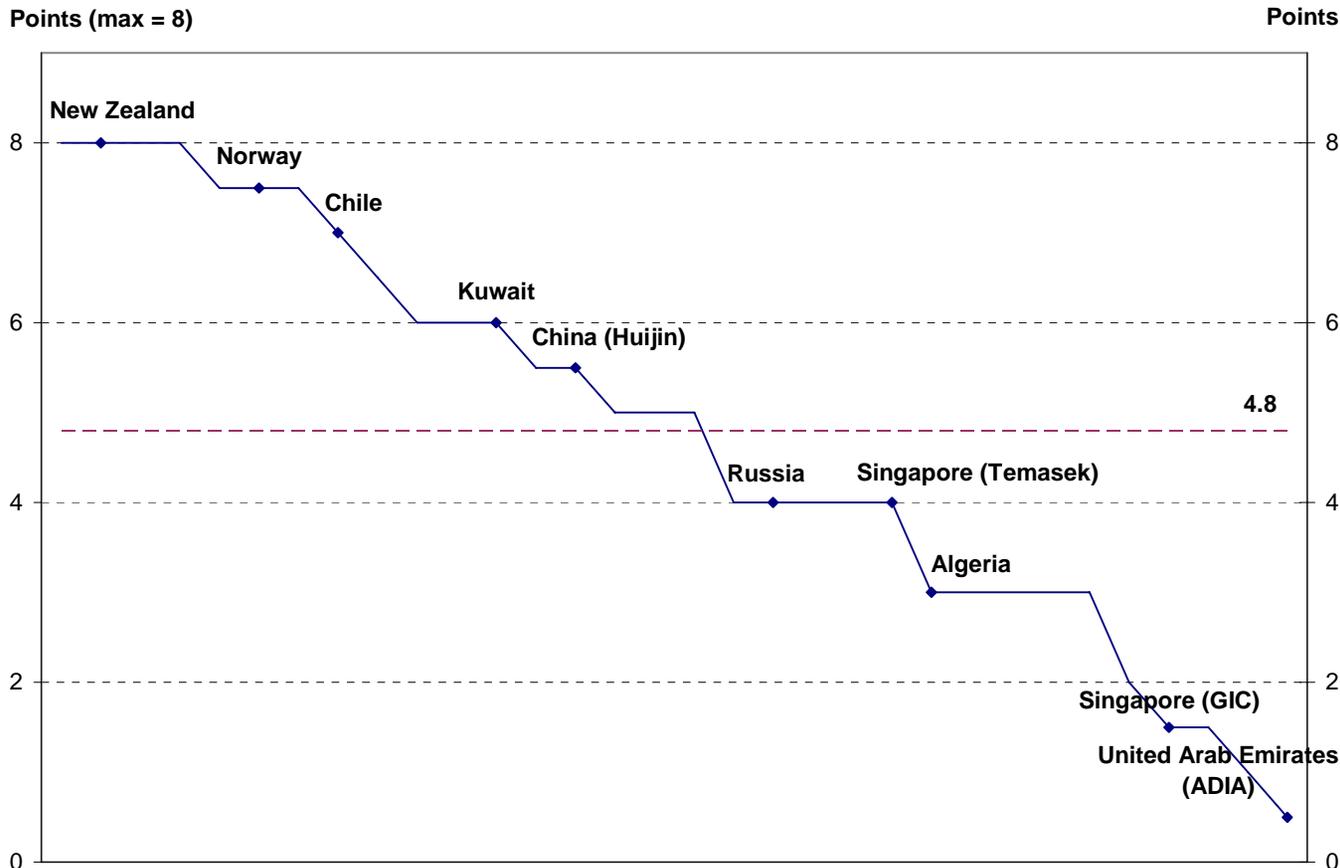
Our **scoreboard** groups **25 elements** in the four categories

# Summary Results



- No SWF scores a perfect 25
- At least one SWF scores a point on each element
- New Zealand and Norway are at the top
- The UAE is at the bottom
- One of Singapore's two SWF scores above average, the other near the bottom
- China's Central Huijin at 6.0 scores below the average of 10.3

# Structure

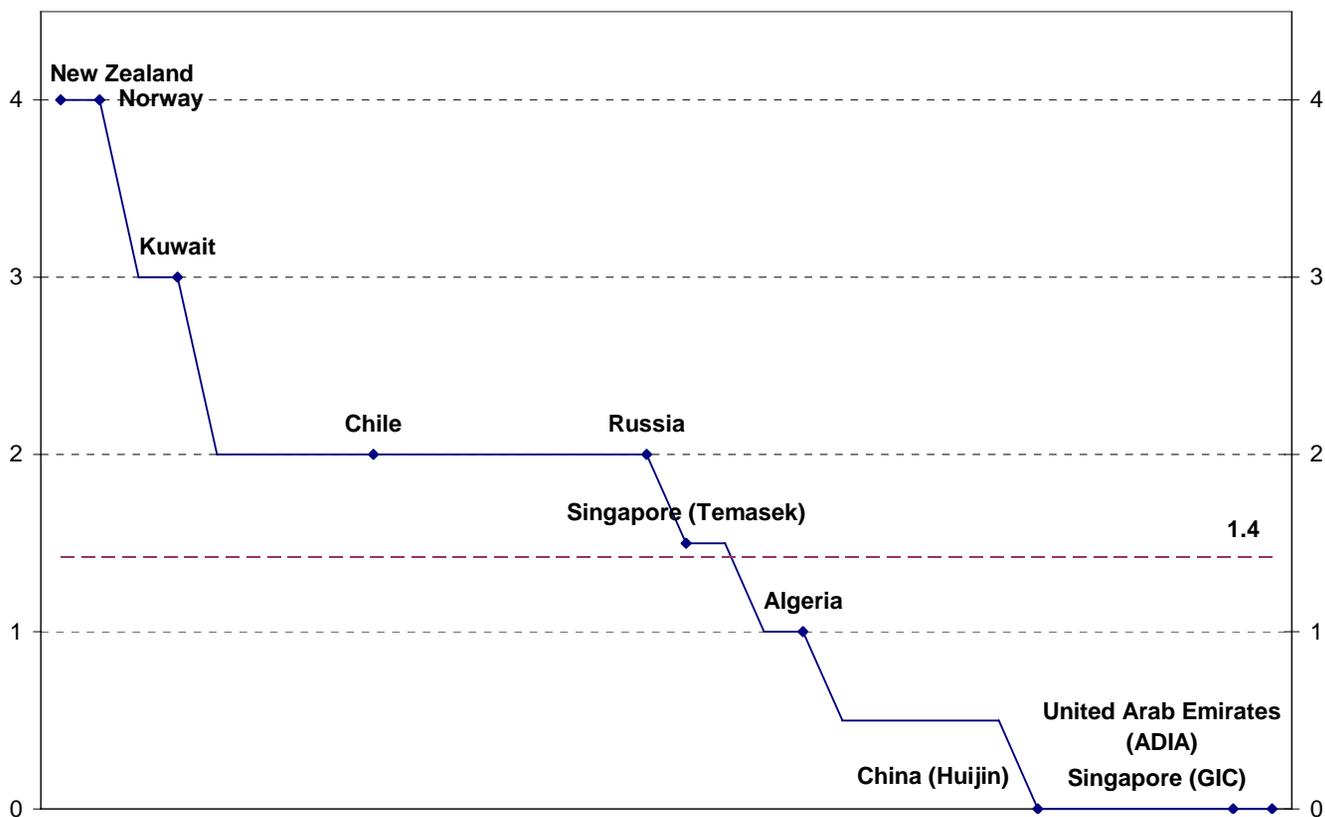


- Category focuses on a well-defined objective, fiscal treatment, etc.
- Average score is more than 50% of the maximum = 8
- Central Huijin scores above the average of 4.8

# Governance

Points (max = 4)

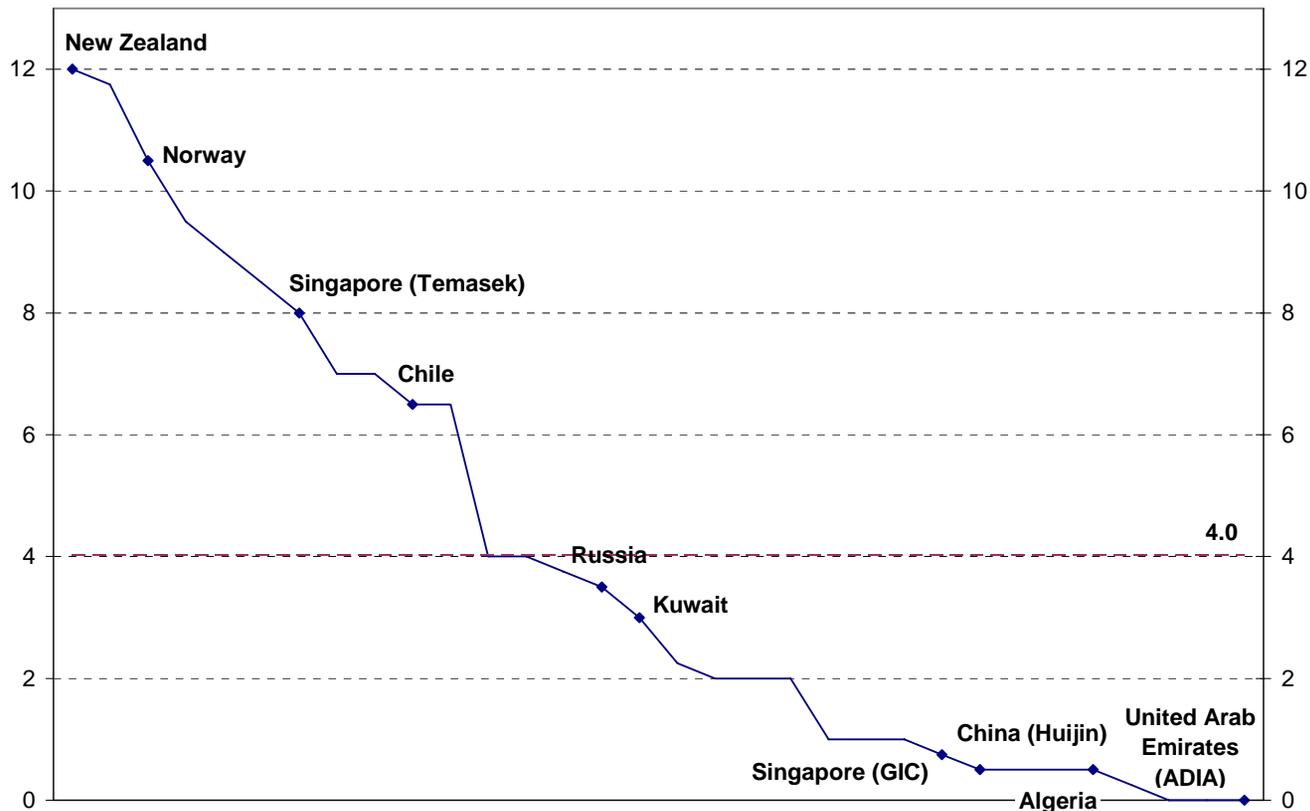
Points



- Category focuses on well-defined roles for the government and the managers and on corporate governance and ethical guidelines
- Average score is only 35% of maximum = 4
- Central Huijin receives no points

# Transparency and Accountability

Points (max = 12)



Points

- Category focuses on the nature of **regular public reporting** on investments and performance
- Average score is 34% of the maximum = 12
- Central Huijin scores ½ point on the types of assets it held

# Implications for China and the CIC

- At present, very little is known about the CIC: “The purpose is to realize a maximization of long-term investment returns with an acceptable risk range” – Chairman Lou Jiwei
- How is this to be accomplished? In particular if 2/3rds of the investments are domestic, where the return is negotiated
- Because of the CIC’s actual and potential size, it will be subject to close scrutiny at home and abroad
  - At home there will be controversies about investment decisions
  - Abroad the CIC may face protectionist reactions

# Conclusion and Recommendation

**Conclusion:** The Chinese authorities should articulate publicly a clear framework for the structure, governance, transparency and other ground rules governing the CIC and its investments

**Recommendation:** The Chinese authorities should embrace the opportunity provided by the creation of the CIC to help shape a set of best practices for Sovereign Wealth Funds – drawing on the elements in our scoreboard