May 24, 2007

Testimony of

Brad Setser
Senior Economist,
Roubini Global Economics and
Research Associate,
Global Economic Governance Programme, University College, Oxford

Before the
US-China Economic and Security Review Commission

"The Extent of the Government's Control of China's Economy and its Impact on the United States"

At the end of 2006, China reported $1.067 trillion in formal foreign exchange reserves. Central Huijin – the vehicle used to recapitalize China's state banks – and the Chinese state banks themselves held an additional $150b in reserve-like assets. All told, China held roughly $1.2 trillion in reserves and similar assets at the end of 2006. China will add another $400 billion, if not more, to that total over the course of 2007. Roughly 70% of those assets likely will be invested in securities denominated in US dollars.

The size of China's reserves is impressive. However, the pace of their growth is of greater importance for the global economy and to the United States' ongoing ability to finance its large external deficit at a low cost. The pace of Chinese foreign reserve accumulation has – by my measure, which counts reserves shifted to the state banks – increased substantially over the past few years. The pace of reserve growth then accelerated even further late in 2006 and in the first quarter of 2007 (Chart 1). While the creation of a new investment fund may slow the pace of formal reserve growth, the overall pace of foreign asset accumulation by the Chinese government is unlikely to slow dramatically.

China's government is now the largest actor in the foreign exchange market, the largest single buyer of US treasury and US "agency" bonds and the largest potential source of demand for many other dollar-denominated financial assets. Consequently, the allocation of China's portfolio is of great interest to many.

This testimony will make emphasis five points:

- The United States' large current account deficit and China's large current account surplus imply rising Chinese ownership of US assets, whether bonds or equities. It is in the long-term interest of both the US and China to reduce the United States' need for foreign financing in general – and Chinese financing specifically – by gradually reducing the US current account deficit and China's surplus. However, overly sharp adjustment would neither be in the interest of the United States nor in the interest of China.
- The foreign assets held by China's government are set to increase rapidly. By late 2008, the sum of China's reserves and the assets managed by the new investment fund will likely top $2 trillion. By 2010, China's holdings easily could reach $3 trillion.
- China's net international investment position is in some ways the mirror image of the US net international position. The US has more foreign liabilities (largely debt) than foreign assets (largely equity investment abroad). China has more foreign assets (primarily US and European bonds held as part of China's foreign exchange reserves) than foreign liabilities (chiefly liabilities from foreign direct investment). Debt securities accounted for 99.5% of China's reported holdings of US securities in mid-2006.
- China has a natural desire to hold a more diverse external portfolio, one that more closely resembles the external portfolio of other major economies. China no longer needs to hold most of its external assets in safe, liquid securities. The proposed investment fund is part of this process. However, some of the

constraints that limit the portfolio choices of China's reserve managers – notably the size of China's purchases and its capacity to move markets – will remain even after the management of China's external assets is split between the State Administration of Foreign Exchange (SAFE) and the new State Foreign Exchange Investment Company (SFEIC).

- China hopes to balance ongoing foreign equity investment in China with Chinese equity investment outside of China. However, China is integrating with the world economy before China's internal corporate governance has fully converged with global norms – including norms in those parts of the Europe where the government retains a strategic stake in some firms. China's state has a large equity stake in many of the Chinese firms that will "go forth."

Point one: Ongoing Chinese surpluses, ongoing US deficits

The United States ran a current account deficit of a bit over $850b in 2006. Its 2007 deficit is likely to be comparable in size. Right now, the current account surpluses that offset the US deficit are overwhelmingly found in East Asia and the world's oil exporting economies. China's current account surplus was $250b (a bit under 10% of its GDP) in 2006. Its 2007 surplus is expected to rise to $350-400b. China's surplus consequently is the counterpart to a growing share of the US deficit.

A current account deficit indicates that a country saves less than it invests; a surplus indicates a surplus of savings over investment. A country, like the US, with a current account deficit consequently must finance its savings shortfall either by placing debt with investors in the rest of the world, attracting large (net) inflows into its equity market or attracting large net inflows of foreign direct investment.

In recent years, foreign equity investment in the US – whether foreign direct investment or foreign purchases of US stocks – has been offset by US equity investment abroad. Inflows through banking system have generally been offset by outflows from banking system. By contrast, foreign purchases of US debt securities have exceeded US purchases of foreign debt, generating a large net inflow.

Foreign central banks – including the People's Bank of China – have been very large net buyers of US debt securities. The People's Bank of China, through the State Administration of Foreign Exchange, likely accounted for a bit over ¼ of all foreign purchases of the US debt securities in 2006, and likely will account for more in 2007.

Foreign central banks have also been increasing their holdings of euro and pound denominated securities. This inflow into Europe has – broadly speaking – helped to finance both current account deficits inside Europe and capital outflows from Europe, including (net) European purchases of US assets. The global flow of funds is complex. However, I do not believe that the US would be able to attract the financing needed to sustain its large current account deficit at current interest and exchange rates in the absence of strong central bank demand for dollar assets.

The size of the US deficit – and the ongoing increase in the United States external debt implied by large ongoing deficits – is a concern. Over time, it is in the interest of the US to run a smaller current account deficit and to finance more US investment out of US savings. Such a shift would reduce the United States' dependence on ongoing inflows from the rest of the world, including United States' dependence on Chinese inflows.

In the near term, however, an overly sharp fall in the US current account deficit – or a sudden fall in Chinese financing of the US, which almost certainly would precipitate a sharp fall in the US current account deficit -- is not in the interest of the US. A fall in Chinese demand for US financial assets would reduce the price – and increate the yield – of US financial assets. This is particularly the case for longer-term bonds, where official demand has helped keep long-term rates low. Higher US interest rates would induce sufficient capital inflows to cover the US deficit or prompt Americans to consume and invest less, bringing the US external deficit in line with available financing. While the fall in the dollar would stimulate exports, other parts of the economy would slow. China also would benefit from a more gradual adjustment process, as it needs time to reorient its economy away from exports and to implement policies that support domestic demand growth.

Gradual adjustment – say 1% of GDP a year -- would facilitate the shift of resource from sectors of the economy that have benefited from the large (net) inflow of foreign savings to the US toward sectors that would benefit from a weaker dollar. However, give the size of the US current account deficit and the lags associated with the adjustment process, any gradual adjustment implies ongoing current account deficits. The US deficit won't fall from between 6% and 7% of US GDP to zero over night. Gradual adjustment consequently implies ongoing capital inflows from the US. Given China's large surplus, Chinese investors will almost certainly need to provide much of that financing.

Point two: The rapid growth in Chinese government assets offsets both China's ongoing current account surplus and the net inflow of private capital.

Large current account surpluses can be offset by large outflows of private capital. Japan's current account surplus, for example, is offset by large outflows of private capital, as Japanese savers move funds abroad looking for higher returns and foreign residents borrow yen at low interest rates to buy other assets. Switzerland is similar to Japan.

However, China's large current account surplus has not been offset by large outflows of private capital. Indeed, China's boom has reduced private Chinese demand for foreign assets (so called "hot" money outflows have dried up) while foreign direct investment continues to pour into China. Chinese policy makers consequently speak of China's twin surplus – the surplus in its current account and the surplus in its capital account.

Such a twin surplus necessarily implies rapid growth in China's foreign exchange reserves – or in other foreign assets of the Chinese government – as China's government, has to generate the capital outflows needed to offset both China's current account surplus and the net inflow of private capital.

China isn't the only government adding rapidly to its foreign assets. Russia's reserves have increased rapidly – in part because Russia also runs a "twin" surplus. More recently, Brazil's reserves have increased rapidly. Many oil exporters in the Gulf are adding rapidly to their foreign assets, though most have opted to add to their government investment funds rather than their central bank reserves.

Consequently, the issues raised by official financing of the US deficit – and the growing role of investment funds or sovereign wealth funds in the global economy – are not unique to China. However, no government is poised to add to its foreign assets at the same pace as China. Strong Chinese export growth continues to drive very rapid reserve growth (Chart 2). China's estimated $350-400b current account surplus and $100b in net private inflows imply a $450-500b increase in the foreign assets of China's governments in 2007 alone.

Point three: China's external position is in many ways the mirror image of the US external position.

The US has substantial external assets as well as external liabilities, but its total external liabilities exceed its assets. The net US international investment position can be divided into a net debt and a net equity position. On net, at the end of 2006 the US likely had borrowed an estimated $5.3 trillion more from the rest of the world than it has lent to the rest of the world. Gross US external debt is close to $9.9 trillion, but it is offset by about $4.6 trillion in US external lending. On net, the US now holds about $3 trillion more foreign equities than foreigners hold US equities. Foreigners hold an estimated $5.8 trillion in US equities (counting FDI), but US holds an estimated $9.1 trillion of foreign equities (also counting FDI). Foreigners also hold an estimated $0.3 trillion in US currency. The negative US net debt position exceeds the positive US net equity position (Chart 3).

The United States' net debt position has deteriorated substantially over the past several years, as the US has relied on foreign purchases of US debt to finance its current account deficit. Unless trends change, the US net debt position will continue to deteriorate. However, in recent years, the capital gains on past US equity investment have offset much of the debt that the US has taken on to finance US current account deficit. Looking forward, continued capital gains on US equity holdings are unlikely to fully offset the United States growing net external debt, so the US net international investment position should deteriorate over time.

China, by contrast, now is a net creditor to the rest of the world, as its external assets exceed its external liabilities. Recent estimates by James McCormack of Fitch Ratings suggest that China held about $1.5 trillion in foreign debt at the end of 2006: $1.07 trillion in reserves, $0.18 trillion ($180b of portfolio debt) and $0.26 trillion of bank loans. Most of the $180b in debt securities not held by the central bank are held by the state banks, often using money borrowed from the central bank (through swaps) or by

state-owned financial institutions. Foreigners hold only $0.3 trillion in Chinese debt (largely from $272b in banks loans to Chinese banks and firms).

On net, China has lent about $1.2 trillion on net to the rest of the world at the end of 2006 – with holdings of US debt securities accounting for a very large share of that net creditor position. Foreigners, however, do have substantial equity investments in China. McCormack estimates that foreigners have $0.7 trillion in FDI in China, and hold another $0.1 trillion of portfolio equity. Most of that equity investment has come from elsewhere in Asia, not from the US or Europe. China, by contrast, has very little equity investment in the world – Chinese FDI is under $0.1 trillion ($79b according to McCormack) and Chinese portfolio equity holdings at the end of 2006 were trivial. China's net equity position is consequently a negative $0.6 trillion ($600b).

China's net international investment position consequently differs from the net international investment position of the Us in several important ways:

- China has more external assets than liabilities; the US has more liabilities than assets
- Most of China's portfolio of external assets is held by the Chinese state, most US external assets are held by private investors.
- Most of China external assets consist of debt, while most US external assets consist of equity.

Neither China's net creditor position nor the large role of China's state in the management of China's external assets is likely to change in the near future. The composition of China's portfolio, however, is likely to evolve.

Point four: China wants to change, over time, the composition of its external portfolio.

The best data on China's holdings of US assets comes from the annual US survey of foreign portfolio investment. As of June, 2006, China held slightly a bit under $700b in US debt: $375b of US Treasury bills and notes, $260b of "agency" bonds, and $60b of corporate debt. In addition, China held slightly over $20b of US equities – and a bit over $15b in plain old bank deposits. At the time, total Chinese holdings of US assets were $735b.

The US data does not distinguish between US assets held by China's private sector (including its state commercial banks) and US assets held by China's State Administration of Foreign Exchange. However, given the size of China's reserves, it is reasonably to assume that the State Administration of Foreign Exchange accounts for most of China's recorded holdings of US securities (Chart 4).

Between thee June 2004 survey and the June 2005 survey, Chinese holdings of US debt increased by slightly more than $185b. Between the June 2005 survey and the June 2006 survey Chinese holdings of US debt increased by slightly under $170b. Since last June, the pace of China's foreign asset growth has accelerated significantly. I estimate

that China's total holdings of US assets will rise by around $265b when data for June 2007 is released. Total Chinese claims on the US now likely approach $1 trillion.

Chinese has been increasing the portion of agency bonds and corporate bonds – most likely mortgage backed securities -- in its portfolio. China bought close to $100b of "agency" bonds between June 2005 and June 2006 – and presumably bought even more over the past year. China consequently is an important source of financing for US households, not just the US government.

While China has a lower fraction of its reserves in treasuries and a higher fraction in agencies and corporate bonds – likely private mortgage backed securities – than most central banks, its overall portfolio still consists overwhelmingly of relatively low yielding US debt. In June 2006, treasuries and agencies accounted for 90% of all Chinese holdings of US securities, and debt securities accounted for 99.5% of China's US portfolio (Chart 5).

China's portfolio consequently looks very different from the portfolio of those countries that have large investment funds. Consider the data on the US securities held by Singapore and Norway, two countries with large investment funds. While Norway's Government Fund is far more transparent than Singapore's GIC or Temasek and we consequently know far more about its portfolios, the US data still provides some clues about both countries' broad portfolios. Equities account for about 60% of the all US securities held by investors in both Norway and Singapore, a far higher proportion than for those countries where central bank reserve holdings likely dominate the data (Chart 5 and Chart 6). Of course, not all the equities held by Norwegian and Singaporean residents are held by their respective investment funds, but given the size of each country's funds, it is reasonable to assume that their investment funds have a large impact on the US data.

The complexities associated with using the US survey data to infer the portfolios of large government investment funds go beyond the fact that the US data – at the country level – combines official and private holdings. The US survey data also almost certainly fails to accurately capture money the world's investment authorities have placed with private equity funds, hedge funds and other private fund managers. This is one potential reason why the Gulf's reported holdings of US assets seem relatively small in relation to the total assets reportedly held by the Gulf investment funds and central banks.

The limited available data on the portfolio composition of major investment funds suggests that they typically hold a much lower share of their portfolio in US assets than a typical central bank. Investment funds holdings of European assets are comparable – or slightly higher than central bank holdings of euros and pounds, but most investment funds have a larger allocation to Asian markets than the typical central bank. Low interest rates in Japan have kept the yen from being an attractive reserve asset.

China's investment fund presumably will aim for a portfolio that mirrors that of other investment funds. It likely will hold more equities (Blackstone is the first example) than

bonds. It will likely invest in likely experiment with participating in hedge funds and private equity funds not just investing directly in listed equities. And it likely will seek to hold more Asian assets.

In the short-run, though, the formation of the investment company and the resulting shift in demand toward equities may have a smaller impact than many suspect. From 2004 to 2006, the rise in oil prices led to a surge in the current account surplus toward the oil exporters and an increase in global demand for equities. Many oil exporters – notably Norway and the smaller oil-exporting states in the Persian Gulf – have large investment funds. Consequently, the shift in the world's current account surplus from Asia toward the oil exporters increased, at the margin, global demand for equities. However, in 2007, rising spending and domestic investment is reducing the current account surplus of the Gulf states even as it pushes up Asia's current account surplus. Demand for equities from China's new investment company consequently will – to a degree – simply offset a fall in demand for equities from some oil investment funds.

Moreover, private equity firms have – to an extent – been able to use strong global demand for debt, including demand from central banks, to finance the purchase of companies. Corporations that have borrowed to buy back some of their equity similarly have used strong demand for debt – and low global interest rates – to generate demand for equities. Demand for equities from actors that borrow in the debt markets to finance their equity purchases may fall as direct demand for equities from Asian investment funds rises.

The initial scale of China's proposed state investment company – most talk suggests a fund of $200-300b – would be comparable in size to the scale of several existing investment funds. Singapore's Government Investment Company is rumored to hold around $300b in assets, Norway's Government Fund manages a $300b portfolio, Kuwait's investment authority manages a rumored $200b and Abu Dhabi's investment authority holds a rumored $500 to $600b. All hold a substantial equity portfolio. China could hold a globally diversified, $200b equity portfolio without necessarily taking an active ownership role. A fraction of the portfolio likely will also be handed over to outside managers.

A portfolio of that size would not eliminate Chinese demand for debt. The formation of the investment company comes at a time when China's foreign asset growth has accelerated. China is currently on track to add $500b to its reserves – up from a bit over $300b, counting the impact of various swap transactions, in 2006. China consequently is in a position where it could increase its purchases of equities without reducing its debt purchases. Indeed, given the difficulties associated with starting up China's fund, China's 2007 purchases are likely to remain heavily tilted toward debt rather than equity. China's $3 billion investment in the US private equity firm Blackstone probably is probably close to equal to its average treasury and agency purchases over two typical working days. China's reserves are increasing by around $10b a week and most of those funds flow into US markets.

However, China's shift toward equities still poses a host of questions.

First, while the initial scale of China's investment fund is comparable to other government investment funds, it potentially could become far bigger. The current pace of accumulation of Chinese foreign assets suggests that China's total foreign holdings will rise above $3 trillion by 2010 – something that implies at least $1.5 trillion in additional accumulation. A world where China creates $1.5 trillion dollar investment fund rather than adds $1.5 trillion to its reserves over the next few years isn't hard to envision. A more modest forecast would have China add roughly equal sums to its reserves and investment fund over the next few years (Chart 7). That still could generate a $900b investment fund by 2010. China's investment fund consequently could quickly become very large relative to existing equity funds. Relative to a scenario where China invests only in bonds, a scenario where China invests primarily in equities might push US interest rates up by as much as 50 basis points – though there are a wide range of estimates of the potential impact of this shift and 50 basis points is at the upper end of that range.

Second, even if China's fund stays in the $200-300b range, China's rumored desire to increase its holdings of emerging Asian equities could potentially generate inflows that are large in relation to their relatively small equity markets. Such inflows could generate political difficulties for China, as other Asian countries wouldn't necessarily welcome Chinese inflows that led their currencies to appreciate relative to China's own currency – or had to be offset by central bank intervention. Most other Asian economies also run current account surpluses, so they do not need Chinese financing – they are already attracting more capital than they need or want.

Smaller Asian countries that intervened to offset increased Chinese demand for equities would in effect be buying the dollars that China no longer wanted – and would need to find a place to invest their own rapidly growing reserves. Consequently Chinese demand for Asian equities might lead to an acceleration in reserve growth in other Asian economies and an increase in their demand for US and European bonds. Smaller Asian economies that let their currencies appreciate would eventually start to run current account deficits, deficits financed in part from inflows from China's investment fund. Such appreciation would facilitate global adjustment.

Third, China's investment fund could potentially take a more active role in the management of companies it invests in, raising a set of issues about control that are avoided by passive positions – or by the use of outside managers. China's investment fund will have the resources to take over major US or European firms if it so desired or, more likely, to take large strategic stakes in foreign firms. This would not be unprecedented: Singapore's Temasek invests actively and both Kuwait's Investment Authority (KIA) and Qatar's Investment Authority (QIA) have taken strategic positions in foreign (mostly European) firms. KIA has large stakes in BP and Daimler; QIA is discussing a major investment in Airbus.

Finally, the formation of an investment fund will not eliminate many of the key constraints that China faces as it tries to allocate its portfolio. So long as China resists appreciation of its currency against the dollar, downward pressure on the dollar translates into downward pressure on China's own currency. If selling dollars to buy other currencies to diversify the currency composition of its portfolio puts downward pressure on the dollar, China cannot change the currency composition of its portfolio without also changing its exchange rate. In my judgment, China is adding to its foreign assets at such a rapid pace that large shifts in what it buys at the margin, not just large shifts in its overall portfolio, can move markets. This constrains China's capacity to easily reduce the dollar's share of its portfolio.

Splitting its foreign assets between a reserve fund and an investment fund will not eliminate China's capacity to move markets. China's investment fund could hold a one third dollar/ one third euro and European currencies/ one third Asian portfolio without putting pressure on the dollar if the State Administration of Foreign Exchange increased its dollar purchases – or, more accurately, stopped selling dollars for euros and in the process raised the dollar share of its portfolio. Total Chinese demand for dollars would remain unchanged. However, if China's central bank didn't offset the actions of its investment fund by raising the dollar share of its remaining reserves, China's total dollar sales would increase. The result would be additional pressure on the dollar.

China's central bank is –I suspect – quite cognizant of the risk that it will be asked to offset pressure on the dollar (and on the RMB) generated by the investment activities of China's investment fund. Some level of coordination will be required.

Despite the complications associated with the creation of the investment fund, China's desire to hold a more diverse portfolio – one less concentrated in relatively low-yielding US bonds – is natural. A rise in Chinese holdings of US equities is a natural by-product of China's large surplus, the United States large deficit and a balanced Chinese portfolio of US assets. Nor would large equity holdings by government-run investment funds be unprecedented. The pension funds of many US states are large players in US capital markets, and the investment funds of Norway, Singapore and many Gulf states already hold substantial quantities of US equities, both directly and through their investment in private equity and hedge funds.

The potential size of China's future portfolio does imply that large government investment funds could start to play the kind of role in US equity markets that central banks currently play in the bond and currency markets. In the first quarter of 2007, the custodial holdings of foreign central banks at the Federal Reserve Bank of New York increased at an unprecedented $550b annual rate - and the New York Federal Reserve Bank's custodial holdings only capture a portion of total central bank holdings of dollar-denominated assets. Edwin Truman of the Peterson Institute has argued that the increased participation of central banks in global markets calls for a higher level of transparency - and specifically more disclosure of their investment strategies as well as the currency composition of their portfolios. I second this suggestion, along with Truman's suggestion that investment funds increase their transparency. Norway's

government fund may not be the best model for all countries, but it comes as close to best practice as we have today.

Point five: The larger role of China's state in China's domestic economy will be mirrored internationally

The precise investment strategy of China's State Foreign Exchange Investment Company is still unknown. I suspect that it will not take controlling stakes in US firms – though it may take large strategic stakes. Its initial investment in the private equity firm Blackstone is a case in point. China avoided taking a position that will give it equity control. In addition to investing in Blackstone itself – which makes its profits from managing others' funds – China's state foreign exchange investment company is likely to seek to participate in various private equity funds, including those of Blackstone, in hedge funds and to hand over a portion of its portfolio to more traditional asset managers.

Direct investment – particularly in strategic sectors – likely will be done in other ways. China's government is actively encouraging Chinese firms to increase their foreign direct investment. Total FDI outflows from China ($17b in 2006) are still small in relation to FDI inflows into China ($78b) and to Chinese purchases of debt securities (around $335b in 2006, according to my estimates, counting securities purchased using China's reserves). Large state owned firms can easily obtain external financing from the state banks to finance external acquisitions.

Such FDI outflows help to reduce pressure on China's central bank (and in the future, on the central bank and investment fund). Every dollar a Chinese firm invests abroad is a dollar the central bank doesn't need to add to its reserves.

China is also increasingly cognizant of the gap between foreign direct investment in China, and Chinese foreign investment abroad. Chinese economists increasingly question whether it makes sense for China – which saves more than its invests and consequently has no need for foreign savings – to offer tax breaks and other concessions to bring in direct investment looking for very large real returns only to turn around and lend the funds direct investors bring into China to the US treasury at a low rate. The gap between foreign direct investment in China and Chinese direct investment abroad – on both a stock and flow basis – can be reduced either by slowing FDI inflows into China or increasing FDI outflows from China.

Viewed from a Chinese perspective, large new Chinese investments in resource production outside of China simply mirror large existing US and European investments in resource production outside of the US and Europe. China sees little reason why say PetroChina or Sinopec shouldn't have a global portfolio of oil-producing assets comparable to the global portfolio of oil-producing assets owned by Exxon Mobile or BP.

China's investment in Blackstone can be viewed as the mirror image of US investments – notably investment by Goldman and the Bank of America in the large Chinese state banks in advance of their IPOs. China's government no doubt hopes that its pre-IPO

investment in Blackstone will generate the same kind of returns US financial institutions have enjoyed on their investments in China's big state commercial banks. China, legitimately, has no desire for Chinese firms to remain in low margin businesses forever. China's government hopes Chinese firms will be able to develop Chinese "brands" or to buy into established Western brands. It is unrealistic to expect that China will only supply labor and cheap financing to US and European firms; over time, Chinese firms will also emerge as global competitors in high-margin businesses as well.

The increase in outward FDI nonetheless raises a host of issues. China's government has a larger ownership role in Chinese companies than European governments have in European companies, let alone the US government has in US companies. That implies that as Chinese firms "go forth," firms owned by the Chinese state will be "going forth."

Conclusion

Financial integration implies rising foreign holdings of US assets and rising US holdings of foreign assets.

But so long as the US is running a large external deficit, foreign holdings of US assets will need to rise faster than US holdings of foreign assets. In many ways, the past few years have been atypical. The United States' external deficit has been financed entirely by the net sale of debt securities rather than by the net sale of equities, in no small part because of unprecedented growth in central bank reserve assets. This pattern is unlikely to persist indefinitely.

The governments of a host of countries that are now adding to their reserves rapidly – not just China – are now considering the formation of investment funds. So long as emerging economies are unwilling to allow their currencies to appreciate and run large current account surpluses – especially with private capital flowing in net into emerging economies, further increasing reserve growth – many governments around the world will be accumulating external asset rapidly. Over time, more of those assets will be handed over investment funds and fewer will be held as reserves. China's investment fund is the most visible example of a broader trend.

China has emerged as a major net creditor globally even though China's government has a far larger role in China's economy, including in the management of China's foreign assets, than the government plays in other major economies. Few in the US have complained about the contribution purchases of US bonds by China's government and state banks have made to low US long-term interest rates. But the role of China's government in the management of China's external portfolio is likely to nonetheless generate new frictions as two trends – the rise in China's total foreign assets and the rise in China's desired holdings of equities – intersect. The growing presence of government investment funds in US equity markets will likely raise a host of questions – questions about US capital market regulation as well as questions about the transparency of large investment funds -- but responding to these concerns by trying to shut government investment funds out of US markets is neither feasible nor desirable.

Charts and graphs

Chart 1

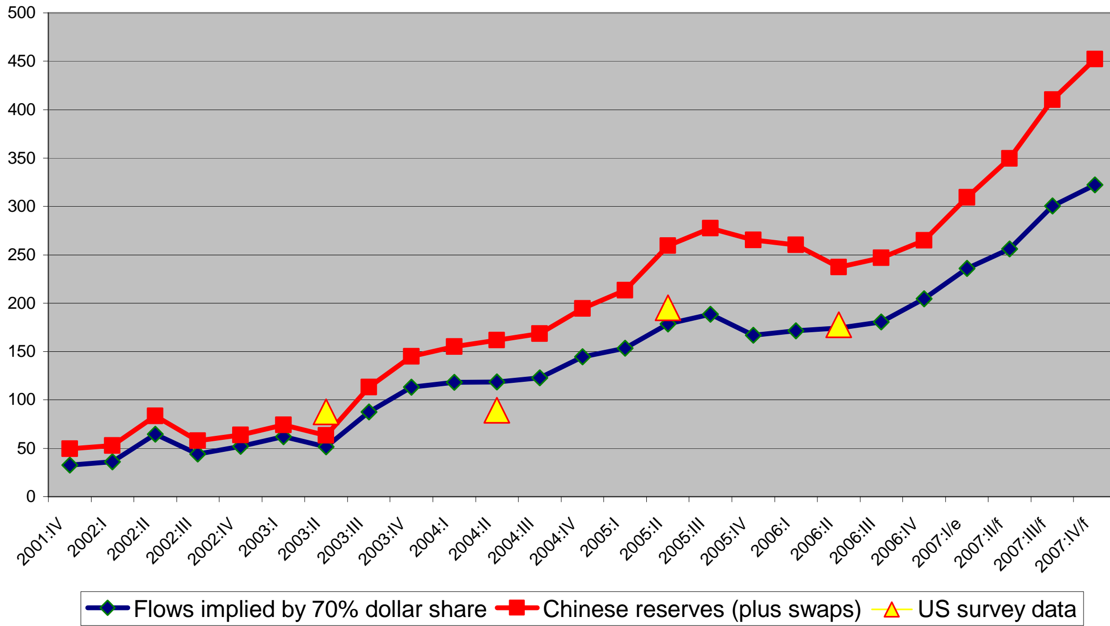


Chart 2

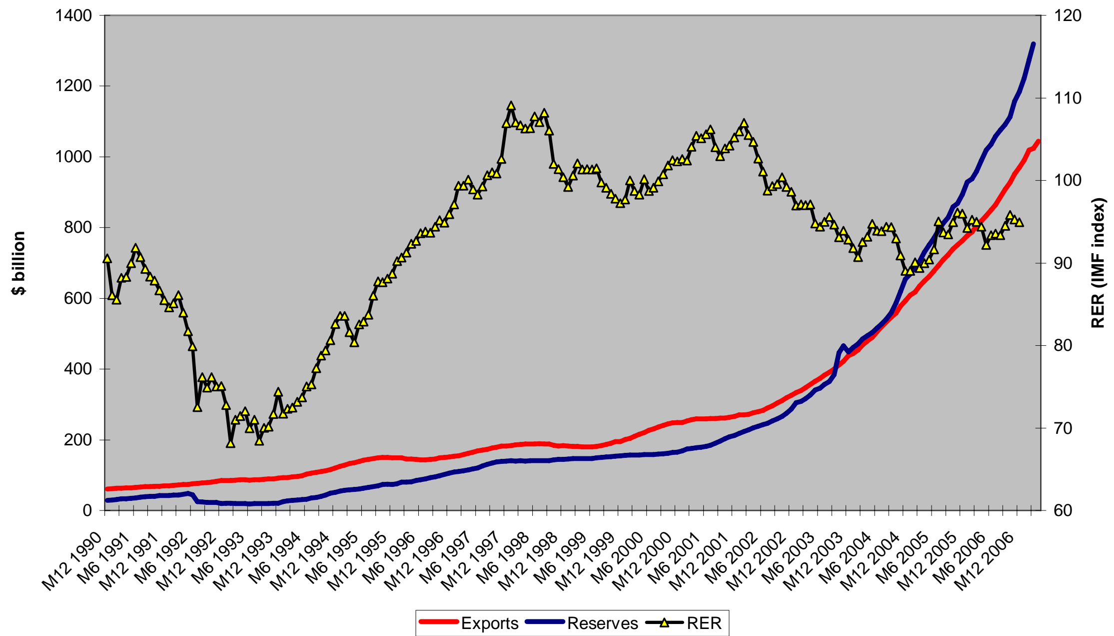


Chart 3:

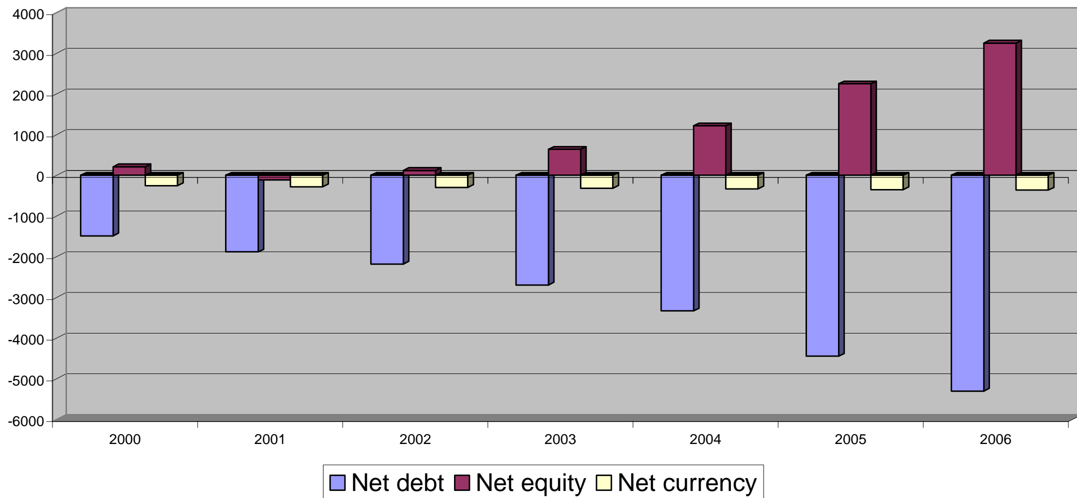


Chart 4:

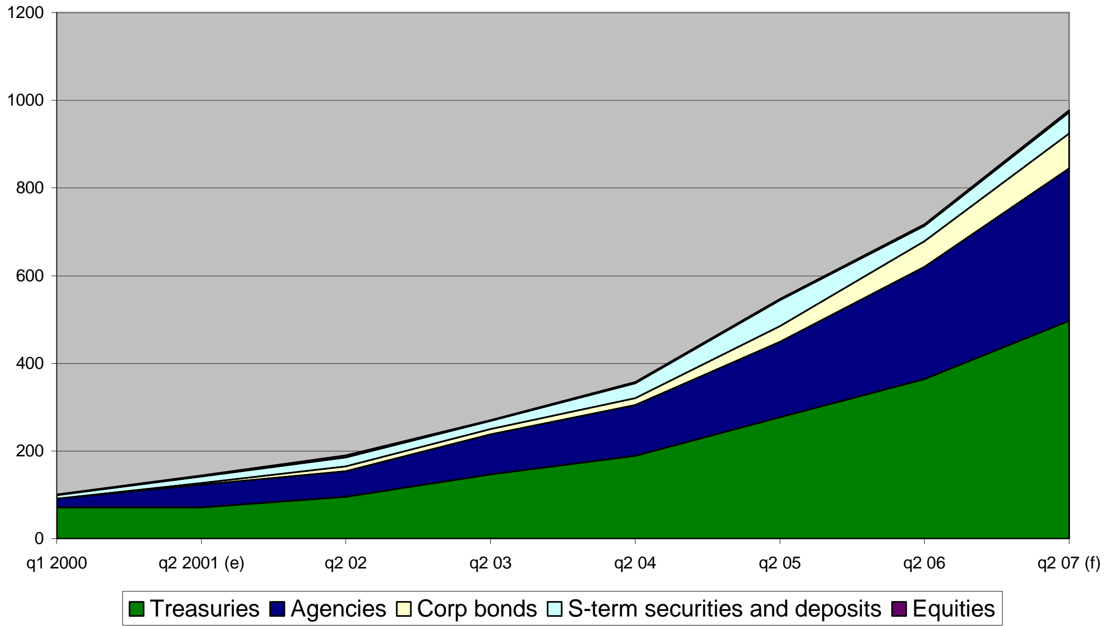


Chart 5

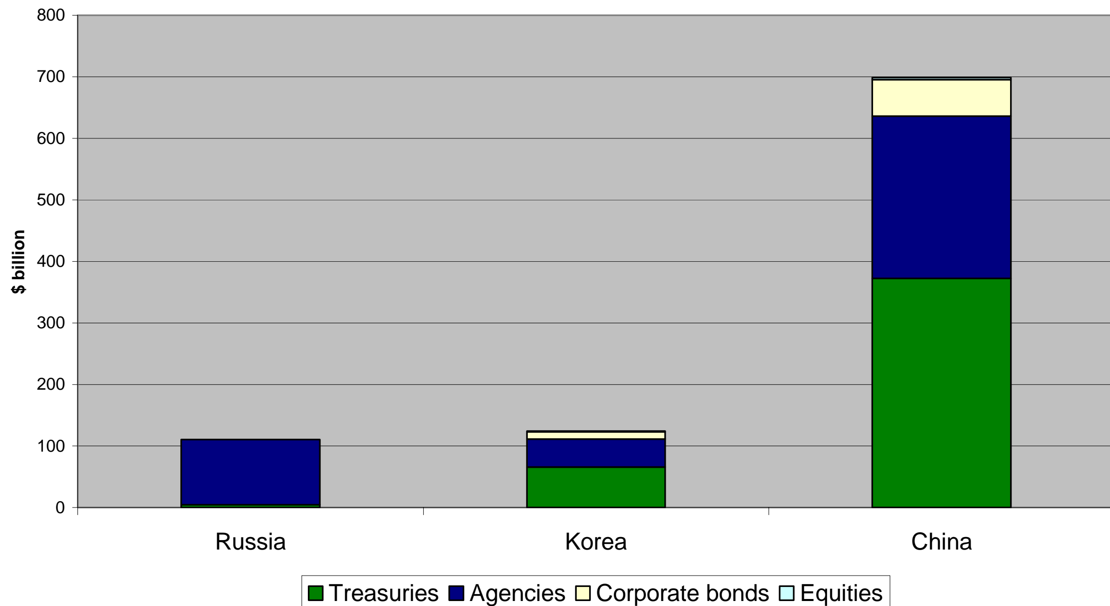


Chart 6

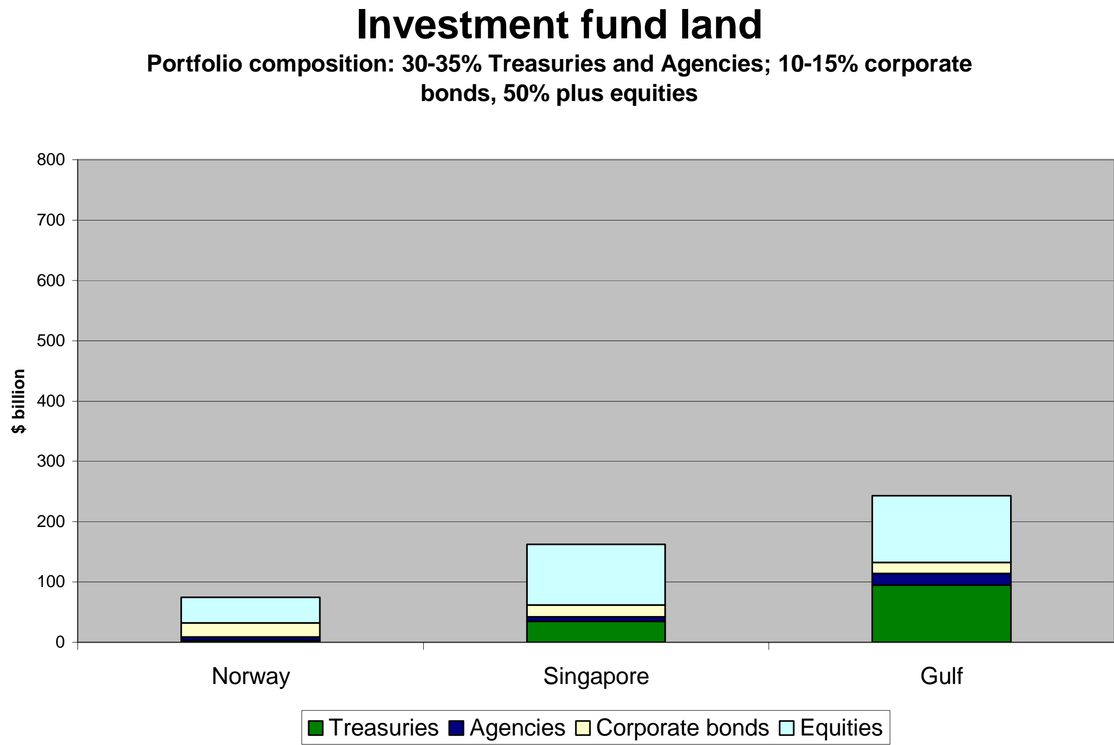
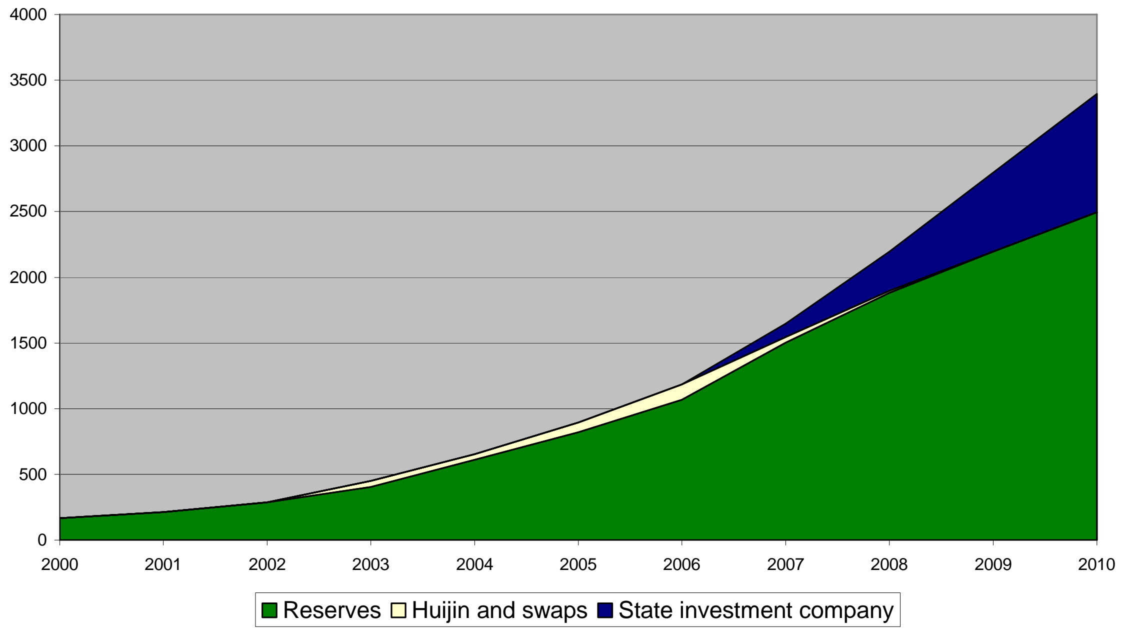


Chart 7


Distribution of Chinese foreign assets over time?
$ billion; 2007-2010 = forecasts
4000
3500
3000
2500
2000
1500
1000
500
0
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
Reserves
Huijin and swaps
State investment company