

## Original Research Article

# Advantages and Disadvantages of Continued Growth in Foreign Exchange Reserves

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### ABSTRACT

Foreign exchange reserves are essential for an open economy. It is an important guarantee to make up for the balance of payments deficit, to intervene in the foreign exchange market, to maintain the exchange rate of the local currency, to repay the external debt and to maintain public confidence. However, the foreign exchange reserves are not as good as possible. China's foreign exchange reserves continued to grow and the high scale of concern, on the high foreign exchange reserves and inflation, the appreciation of the renminbi pressure, holding costs of more research. This paper first introduces the concept of foreign exchange reserves, and analyzes the root causes of the growth of China's foreign exchange reserves. Combined with previous research results to explore China's foreign exchange reserves continued to grow on the positive and negative effects of the economy.

**KEYWORDS:** foreign exchange reserves; positive effects; negative effects; surplus inflation; renminbi

## 1. Foreign exchange reserves

Foreign exchange reserves are the mainstay of international reserves in most countries today and are the most frequently used and the largest in the international reserve assets. Foreign exchange reserves are the cash, cash and foreign currency financial assets or equity vouchers of convertible foreign currencies held by a government. In the narrow sense, foreign exchange reserves are an important part of a country's economic strength, a foreign exchange accumulation that is used by a country to balance the balance of payments, stabilize the exchange rate and repay the external debt. Broadly speaking, foreign exchange reserves refer to foreign exchange-denominated assets, including cash, foreign bank deposits and foreign securities. Foreign exchange reserves are an important part of the international clearing power of a country and have an important impact on balancing the balance of payments and stabilizing the exchange rate.

The functions of foreign exchange reserves mainly include the following four aspects:

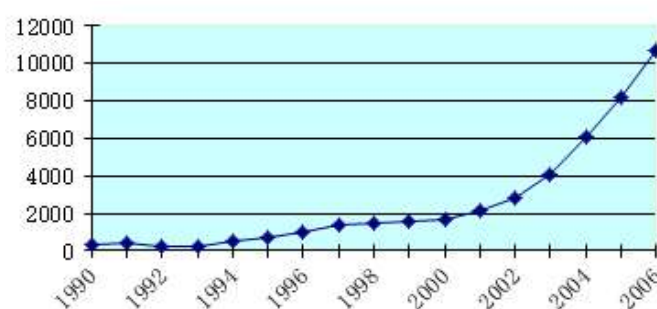
1. Adjust the balance of payments, to ensure that external payments.
2. Intervene in the foreign exchange market, stabilize the local currency exchange rate.
3. The maintenance of international credibility, improve financing capacity.
4. Enhance the overall national strength, resistance to financial risks.

Certain foreign exchange reserves are an important means for a country to carry out economic regulation and achieve internal and external balance. When the international balance of payments, the use of foreign exchange reserves can promote the balance of payments; when the domestic macroeconomic imbalance, the total demand is greater than the total supply, you can use foreign exchange organizations to import, thus regulating the total supply and the relationship between aggregate demand, promote macroeconomic balance. At the same time when the exchange rate fluctuations, you can use foreign exchange reserves to intervene in the exchange rate, so that stabilized. Thus, foreign exchange reserves are an indispensable means of achieving economic equilibrium and stability, especially in the context of the continuous development of economic globalization and the fact that a country's economy is more vulnerable to economic impact from other countries.

## 2. China's foreign exchange reserves and the reasons for its continued growth

Before 1978, China implemented a highly centralized planned economic system, less involved in international economic exchanges. China's foreign exchange reserves are limited. Since the reform and opening up, China's economy has developed rapidly and the degree of opening up has been continuously improved. In the context of economic and financial globalization, China's international balance of payments has undergone great changes. With the increase in foreign trade and the large inflow of foreign capital, the huge balance of payments surplus makes the accumulation of foreign exchange reserves faster and faster. In 1980, China's foreign exchange reserves were only US \$ 2.26 billion. By 1981, foreign exchange reserves stood at 118.9, an increase of 429%. Followed by annual foreign exchange reserves are also steady growth. Into the twenty-first century, China's foreign exchange reserves appear unusually. In 2001, foreign exchange reserves amounted to 212.17 billion US dollars, an increase of 46.6 billion US dollars, an increase of 28.15%; to 2002 foreign exchange reserves of 286.11 billion US dollars, an increase of 74.24 billion US dollars over the previous year, the growth rate of 34.99% ; To the end of 2004 foreign exchange reserves of 609.93 billion US dollars, an increase of 2066.8 billion US dollars, a growth rate of 51.25%: as of the end of 2006, China's foreign exchange reserves reached 1066.3 billion US dollars, becoming the world's largest foreign exchange reserves. See below for details.

China's foreign exchange reserves in recent years



(Source: IMF International Yearbook of Financial Statistics)

What is the reason for the continued growth of China's foreign exchange reserves? What is the reason to accelerate the growth of China's foreign exchange reserves? China's foreign exchange reserves growth is affected both by the external environment and its internal factors.

(1) The external environment: the world economy, financial integration. With the globalization of the world economy, the integration process in depth, the world's financial, trade has been an unprecedented development. Rapid growth in trade volume, capital flows to speed up, the scale of multinational companies continue to expand, increasing the number. In this trend, China has enjoyed the benefits of international division of labor. From the perspective of international trade, the share of China in the ever-increasing world trade volume has increased year by year.

(2) Internal factors. China's foreign exchange reserves continue to grow more internal factors, mainly due to the national macroeconomic operation is good. Since the reform and opening up in 1978, China's macroeconomic policy has always adhered to the 'reform and opening up' words and words. In the expansion of foreign trade at the same time, the positive introduction of foreign investment, China's balance of payments year after year surplus. In terms of current account, due to the rapid development of international trade, the increasing trade surplus, the huge current account surplus is the overall balance of payments in China, thus laying a solid foundation for the continuous growth of foreign exchange reserves. In terms of capital projects, mainly due to foreign direct investment in China continued to increase. In general, due to the implementation of modest macroeconomic policies by the state, the country's economy is running well, exports of goods and foreign direct investment (FDI) continue to grow, showing a year-on-year surplus in the balance of payments, Foreign exchange reserves are the source of sustained and rapid growth of China's foreign exchange reserves.

## 3. China's foreign exchange reserves continue to grow positive effect

Certain foreign exchange reserves are an important means for China to carry out economic regulation and achieve internal and external balance. In general, the increase in foreign exchange reserves not only can enhance the ability of macroeconomic regulation and control, but also conducive to maintaining national and business reputation in the international community, help to expand international trade, attract foreign investment, reduce domestic enterprise financing costs, prevent and resolve international Financial risk.

1. Sufficient foreign exchange reserves to China's international payment capacity significantly enhanced and improved China's overall national strength. Foreign exchange reserves are an important indicator of a country's

comprehensive national strength. With the continuous development of China's open economy, China's foreign trade has expanded rapidly and the dependence on foreign trade has been continuously improved. Therefore, maintaining a sufficient foreign exchange reserves not only improves China's overall national strength, but also provides an effective guarantee for China to maintain its international payment capacity in international trade and to adjust its balance of payments.

2. Sufficient foreign exchange reserves to enhance the solvency of China, to improve China's international reputation. International financial institutions and banks in foreign loans, often in advance to investigate the debtor's ability to repay the debt. The state of foreign exchange reserves held by a country is one of the important indicators of credit investigation and evaluation of national risks. For China's foreign debt borrowed from foreign governments and international financial institutions, due to the different investment income and recovery period, it is necessary to hold sufficient foreign exchange reserves to prevent the debt and credit crisis.

3. Sufficient foreign exchange reserves so that China can effectively intervene in the foreign exchange market, to maintain the currency exchange rate stability. The number of foreign exchange reserves owned by a country indicates its ability to intervene in the foreign exchange market and maintain the exchange rate of the local currency. When the renminbi is under pressure to devalue in the short term, the central bank will buy foreign exchange and sell the renminbi. On the contrary, when the yuan is under devaluation, the central bank will throw out foreign exchange reserves and buy RMB to maintain the exchange rate basically stable. China's current implementation of the market supply and demand based on a managed floating exchange rate system, adequate foreign exchange reserves for China to effectively prevent the financial crisis, to maintain the stability of the RMB currency and investor confidence has an important role.

4. Adequate foreign exchange reserves to effectively promote the domestic economic development. First, sufficient foreign exchange reserves can improve China's external financing capacity, reduce the domestic institutions to enter the international market financing costs, to encourage domestic enterprises to 'go out' to seek a better investment environment and greater profit margins; Second, sufficient foreign exchange reserves In the deepening of economic reform, adjust the industrial structure, improve production technology and so can play an important role. With China's accession to the WTO, the development of foreign trade greatly accelerated, sufficient foreign exchange reserves to meet the needs of imported advanced technology and equipment; third is to a greater extent to meet the residents demand for foreign exchange.

5. Sufficient foreign exchange reserves is the ultimate realization of the renminbi can be fully convertible a necessary condition.

#### **4. China's foreign exchange reserves continue to grow the negative impact**

Foreign exchange reserves as a national economic and financial strength of the symbol, it is to make up for their own international balance of payments deficit, to resist the financial turmoil, stabilize the national exchange rate and maintain the international credibility of the material basis. For developing countries, foreign exchange reserves are often held above the conventional level. However, foreign exchange reserves are not much better, in recent years, the rapid expansion of China's foreign exchange reserves on the economic development had a lot of negative effects.

1. High foreign exchange reserves caused by holding costs are too high, resulting in idle resources and funds. In China's foreign exchange reserves, borrowed loans accounted for a larger proportion of interest costs are relatively high. Because foreign exchange reserves are a symbol of real resources, its holdings are costly. The opportunity cost of holding a foreign exchange reserve is equal to the domestic capital productivity minus the rate of return on holding foreign exchange reserves. If China holds huge foreign exchange reserves and borrows a large amount of foreign debt, it is equal to the low cost of domestic funds to foreign countries to foreigners, while at high prices from abroad to borrow funds, the potential loss is obvious. At the same time, holding a foreign exchange reserve indicates that the use of a certain amount of actual resources is temporarily abandoned, and thus the economic growth and income levels caused by these inputs are lost. Therefore, when borrowing the reserve ratio is too high, too much holding foreign exchange reserves is neither economic nor will it affect the growth of the domestic economy.

2. High foreign exchange reserves is the main reason leading to the current liquidity surplus in China, and to a certain extent, exacerbated the inflationary pressures. Excessive liquidity refers to the supply of money exceeds the real economy's demand for money, its growth rate exceeds the real GDP growth. In China's money supply, foreign exchange accounts have accounted for about 70%. In the case of the forced sale and sale of foreign exchange, the central bank is willing to buy foreign exchange, thus placing the base currency accordingly, and by the effect of the multiplier effect, the money supply will be greatly increased, thus creating the pressure of excess liquidity and current inflation.

3. The rapid growth of foreign exchange reserves exacerbated the pressure of RMB appreciation, thereby affecting the competitiveness of China's export commodities. Theoretically, the increase in foreign exchange reserves in a country would make the currency exchange rate rise. From the actual situation in China, the RMB exchange rate with the increase in foreign exchange reserves and gradually increased from 1994 to 1 US dollar against 8.7 yuan, rose to

the current one US dollar against 6.67 yuan, the appreciation rate of 23.33%. In China's foreign trade and exports, enterprises to lower prices dominate the international market, and the RMB exchange rate continued to rise in the situation, the Chinese enterprises to increase the price of export commodities, many small and medium-sized foreign trade enterprises because of the price advantage and bankruptcy collapse. Therefore, the rise in the RMB exchange rate is clearly detrimental to China's export growth.

4. High foreign exchange reserves, increasing the difficulty of reserve asset management and risk. In the financial globalization today, due to the rapid flow of international capital large-scale flow, the financial market interest rates and exchange rate fluctuations are very intense. As a national wealth of foreign exchange reserves, its size is too large will make the country's wealth at a huge risk, high reserves of foreign reserves to reserve assets, value-added management has brought difficulty. In China's \$ 2.4 trillion in foreign exchange reserves, dollar assets accounted for about 70%, the yen is about 10%, the euro and the pound is about 20%. US Treasury Department announced on February 26 this year, the revised data show that China's dollar assets held by \$ 894.8 billion investment in US Treasury bonds, and now has 900 billion US dollars of US Treasury bonds, of which long-term US Treasury bonds 825.1 billion US dollars, Accounting for 92% of China's holdings of US Treasury bonds. It can be seen that China's foreign exchange reserves are mainly to invest in US Treasury bonds, which will bring two related issues: First, the dollar in recent years showing a weak trend of development, the exchange rate fell, the dollar continued to depreciate, Then China's foreign exchange reserves of US dollar assets will be 'shrinking', resulting in huge losses. Second, more than half of China's foreign exchange reserves to buy the US Treasury bonds, objectively vulnerable to others. In the big pattern of economic globalization, once the international turmoil, the United States can put our hands in the huge dollar bonds to freeze, to sanction and retaliate against China, China had to prevent.

5. The growth of excess foreign exchange reserves to China's monetary policy almost failed. Due to overheating of China's economic development over the past two years, a variety of fixed assets investment too fast, rising consumer prices, real estate and other asset prices soared, the central bank in order to control this momentum, to take some tight monetary policy, and constantly raise interest rates and finance Institutional deposit reserve ratio, designed to control the problem of excess liquidity. But the foreign exchange reserves continue to increase, and thus corresponding to the base money, which will greatly weaken the effect of monetary policy, that is, on the one hand, tight monetary policy to absorb too much money, on the other hand, the increase in huge foreign exchange reserves will put a lot of base money.

6. Continued growth in foreign exchange reserves will also increase trade friction. By the international financial crisis, global trade in 2009, the sharp decline in total. Although the total import and export volume of China's foreign trade has also experienced a significant decline, but due to response, effective measures, still the annual export of 1.2 trillion US dollars has become the world's largest trade exporters, in the international trade market share To further enhance the foreign exchange reserves have increased, coupled with the recovery of China's economy, the country to China to prevent and alert to enhance the psychological, leading to increased trade frictions, so that China's complex foreign trade situation has become more severe. In particular, trade protectionism tends to intensify. In 2009, China suffered the most severe trade frictions. It became the largest victim of trade protectionism. A total of 22 countries and regions launched 116 trade remedy investigations to China The total amount of up to 12.7 billion US dollars, up 23% year on year, 102%, have reached the highest value in history. Among them, the US trade remedy case involving China amounted to 7.6 billion US dollars, more than 5 times the previous year. At the same time, India, Brazil, Argentina, Mexico and other developing countries have also launched anti-dumping and countervailing investigations on China's export products.

## **5. Conclusions**

In order to maintain the healthy, stable and sustainable development of China's economy, we must strengthen the situation and strengthen the construction of China's foreign exchange reserve management and operation mechanism, starting from the financial security and the effectiveness of the national foreign exchange reserves, For China's foreign exchange reserves management and operation to find a more scientific and rational new ways.

To properly adjust foreign policy, we should learn from the international experience, in the process of introducing foreign capital, to the quality of the fundamental control of the scale of foreign investment to ensure that cited and effective; need to pay more attention to imports, international trade is imported and exported together, too large trade surplus is also a manifestation of economic development imbalance, while ensuring the export at the same time, the appropriate expansion of imports, is conducive to the balance of the domestic market; strong foreign exchange assets, risk management. Through the strengthening of risk management; can reduce or avoid losses in the operation of foreign exchange assets, improve the rate of return; to promote the diversification of the use of official foreign exchange reserves; gradually relax the control of capital projects to encourage enterprises to invest abroad. Improve the exchange rate formation mechanism, expand the floating rate of the RMB exchange rate.

In summary, the foreign exchange reserves cannot be too little, nor too much and the size of foreign exchange reserves must be reasonable and appropriate. Multi-pronged approach, the full use of various management tools, especially in the current economic recession, the maintenance of China's economic security and interests.

The state foreign exchange authorities confirmed that China's foreign exchange reserves reached US \$ 853.6 billion in February this year. According to the Japanese Ministry of Finance data released in March, as of the end of February this year, Japan's foreign exchange reserves of 850 billion US dollars. The figures show that China surpassed Japan for the first time to become the world's first foreign exchange reserves.

'The world's first' foreign exchange reserve country behind the name, reflects a series of subtle and complex signals, cause for concern. And 853.6 billion US dollars of foreign exchange reserves is mostly less, is good or bad, but also once again lead to hot.

When China's foreign exchange reserves in recent years at an annual rate of 200 billion US dollars rising, the market appeared on the holdings of high foreign exchange reserves of the pros and cons. With the status of China's largest foreign exchange reserves, the status of the first big country surfaced, 853.6 billion US dollars of foreign exchange reserves is mostly less, is good or bad, once again become the focus of attention.

'China's foreign exchange reserves are not high.' People's Bank of China Governor Zhou Xiaochuan recently held in the China Development Forum held a speech, said that if similar countries, the level of external debt is different, the foreign exchange reserves are not high, , FDI (foreign direct investment) the total level of stock is different, foreign exchange reserves may be different. Foreign debt is to be, FDI to dividends, it is possible to withdraw. In addition, there is hot money, then it will wait for an opportunity to withdraw. These factors have an impact on the number of foreign exchange reserves. From the per capita scale, China's foreign exchange reserves are not high.

If China's 1.3 billion population to calculate, China's current per capita foreign exchange reserves of only 600 US dollars, less than one-tenth of Japan, compared with Singapore is also very different.

How much is normal, of course, a certain amount of foreign exchange reserves, for strengthening the national macro-control capacity, to prevent international financial risk is of great significance.

Ministry of Commerce Trade and Industry Research Institute Mei Xinyu said that with such a huge foreign exchange reserves, means that China has ample international ability to pay, will not be the debt crisis or suppress the currency exchange rate speculative currency knocked down.

The number of foreign exchange reserves to be normal? Industrial and Commercial Bank of China branch in Gansu Province, said Zhao Peng, the international exchange of foreign exchange reserves to support foreign trade as a measure of foreign exchange reserves of the important indicators, generally believed that the minimum foreign exchange reserves cannot be less than three Month import requirements, and as a warning line. In accordance with international experience, foreign exchange reserves and foreign debt balance ratio of 30%. In 2005, China's total foreign trade amounted to approximately US \$ 1.42 trillion, and the total external debt was US \$ 250 billion. If coupled with the need to remit profits from foreign-invested enterprises, the demand for financial reform and the need for foreign exchange from time to time, China The best scale of foreign exchange reserves should not exceed 550 billion US dollars, while China's current foreign exchange reserves have far exceeded the optimal size.

High reserves show three drawbacks:

Foreign exchange reserves are not 'much better'. Foreign exchange reserves remain high, on the one hand increased the pressure on foreign exchange, resulting in financial regulation and control difficulties, is not conducive to China's economic development; the other hand, will further aggravate trade friction, grant people to mouth. In addition, it also increased the pressure on operating huge foreign exchange reserves.

Some experts pointed out that the base money and foreign exchange increased, but also restricted the use and effect of monetary policy. As the foreign exchange reserves are purchased and held by the state, the corresponding accounts in the accounts of the SAFE are foreign exchange, and the increase in foreign exchange deposits directly increases the supply of base money, and then through the money multiplier effect, The substantial increase in money supply has not only exacerbated the pressure of rising prices, but also weakened the ability of monetary regulators to control money supply and its effects.

In addition, high foreign exchange reserves reduce the efficiency of the use of funds, resulting in waste of funds. High foreign exchange reserves also increased the cost of foreign exchange reserves, increasing the risk of reserves.

What is foreign exchange reserves?

The so-called foreign exchange reserves, is a currency authorities held by the country can be used to pay foreign convertible currency. Not all countries' currencies can act as international reserve assets, and only those currencies that occupy an important position in the international monetary system and are freely convertible to other reserve assets can

act as international reserve assets. China and other countries in the world foreign trade and international settlement often used in foreign exchange reserves are the US dollar, the euro, yen, sterling and so on.

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