ECONOMIC VIEWPOINT

China's Surplus and the Bid for Bonds

By Mirza Shaheryar Baig, Foreign Exchange Strategist

According to some commentators, China's reserve managers are gradually stepping back from the US Treasury market, removing what was once an important source of demand for government bonds.

The claim rests on two observations. First, China's official holdings of US Treasuries have been falling for more than a decade. Second, China is settling more of its trade in renminbi rather than dollars, reducing the need to recycle dollars into foreign assets.

But this narrative is incomplete. The task of recycling China's massive current account surplus has shifted from the central bank to the country's largest state-owned banks. These banks are using the surplus to repay foreign debt and accumulate large portfolios of US dollar bonds. **China's exit from US dollar assets has been greatly exaggerated.**

However, banks are different from reserve managers in one crucial way: they must manage their market risk. Unlike a central bank, they cannot simply plough every surplus dollar into long-duration bonds and hold them to maturity. They must mitigate their exposure to interest rates, credit spreads and funding costs via duration strategies and derivatives. As a result, the shift from official reserve managers to state-owned banks has **transformed China's recycling flow from a largely price-insensitive buyer into a more commercially driven, price-sensitive buyer of global bonds that actively manages its duration exposure**.

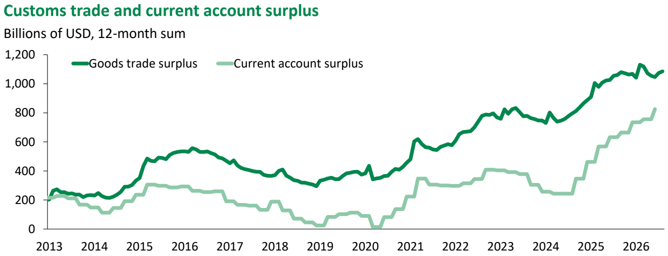
Here's the full story.

How Large Is China's Surplus?

China's customs trade surplus (goods exports minus imports) is now more than US$1 trillion per year. The broader **current account surplus over the last four quarters was US$826 billion**. On both measures, China's external surplus has surged to record highs since COVID-19.

China's industrial policy continues to channel resources toward manufacturing, while weak consumer demand and intense domestic competition encourage firms to seek sales abroad. Chinese companies are also moving up the value chain and building globally recognized brands such as BYD (EVs), Huawei (technology) and Xiaomi (consumer electronics). Despite growing pushback from both the US and the EU, we expect **China to continue running outsized external surpluses for the foreseeable future**.

Graph 1
China's External Surplus Has Surged



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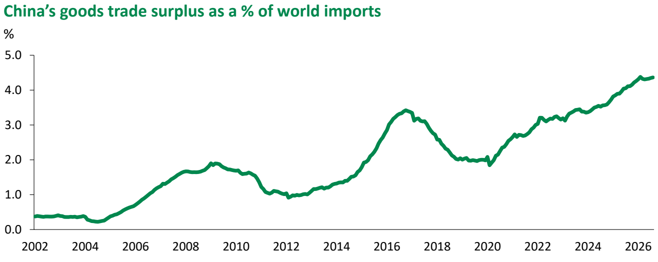
Graph 2
Made in China, Bought by the World



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Why Isn't the Surplus Showing Up in Official Reserves?

China's exchange rate is heavily managed by the People's Bank of China (PBoC), the central bank. Historically, surplus dollars were absorbed into official reserves to prevent the renminbi from appreciating. But this is not the case today. For instance, the PBoC reported its official reserves increased by only US$115 billion in the last four quarters, which accounts for only one-eighth of the current account surplus. Where did the rest go?

Long-time China watchers such as Michael Pettis argue that the Chinese state continues to intervene heavily in the foreign exchange market. But it increasingly does so through state-owned banks rather than the PBoC. Why? The most likely motives could be to cloak their market intervention or to reduce vulnerability to financial sanctions after the freezing of Russia's foreign reserves.

As such, **official reserves don't give the full picture**, as they don't capture the "shadow" reserves building up at the large banks.

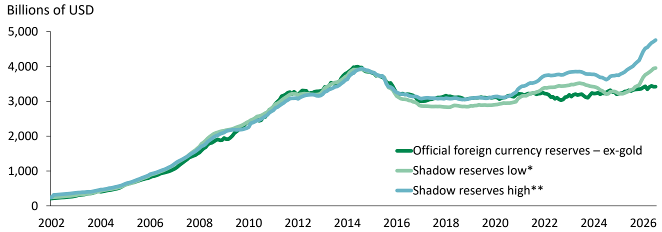
How Fast Are These "Shadow" Reserves Growing?

There are different ways to measure this. The basic intuition is simple: when Chinese companies earn foreign currency through exports, they can either convert those proceeds into renminbi or leave them in foreign-currency accounts with domestic banks.

The first can be tracked using forex settlement data from the State Administration of Foreign Exchange (SAFE – the official reserve manager and forex regulator), which records how much foreign currency firms sell for renminbi net of how much foreign currency they purchase using renminbi. The second can be proxied by foreign-currency deposits held by residents in the Chinese banking system.

We use these two datasets to construct low and high estimates of China's "shadow" reserves (graph 3). Over the past 12 months, the low estimate comes to US$639 billion and the high estimate to US$785 billion. The midpoint, **roughly US$710 billion per year**, provides a useful reference point.

Graph 3
China Continues to Intervene in Forex



* Net forex settlement; ** Add: foreign currency deposits of residents.
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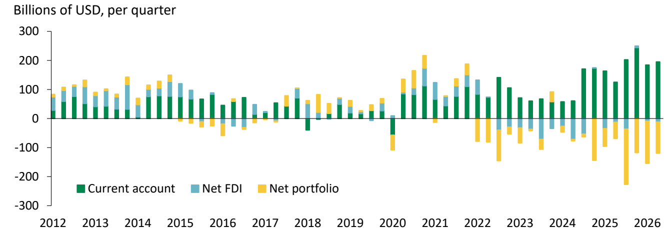
But Aren't Portfolio Outflows Recycling the Current Account Surplus?

According to China's balance of payments data, the current account surplus is largely recycled via portfolio outflows (graph 4). Outward portfolio investment totalled US$1.3 trillion over the last 12 months, easily offsetting the current account surplus.

Graph 4
Are Portfolio Outflows Recycling the Surplus?



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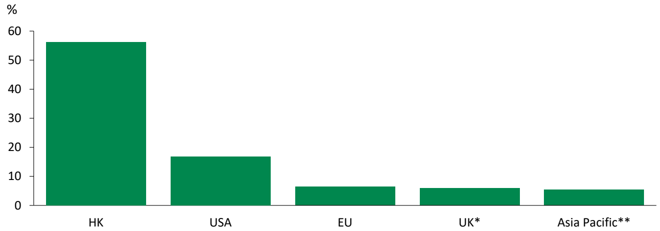
But what exactly are these "portfolio" outflows? If Chinese savers were sending more than US$1 trillion abroad to buy foreign securities, we would find asset managers of commensurate size. But there is no Chinese version of BlackRock or Vanguard. In fact, China's outward portfolio investment is tightly regulated. The country's main portfolio investment channel, the Qualified Domestic Institutional Investor (QDII) program, has a quota of only about US$183 billion. The National Social Security Fund, China's closest equivalent to the Canada Pension Plan, manages roughly US$500 billion in assets but has only about US$60 billion invested overseas.[1]

Another clue lies in where these portfolio assets are located. IMF data shows that more than half of China's portfolio assets are in Hong Kong (graph 5 on page 3). The territory is the main gateway between mainland China and global capital markets, and China's state-owned financial institutions have a large presence there. Hong Kong appears to be a conduit rather than the ultimate destination for much of China's outward portfolio investment.

[1] The other well-known asset managers are SAFE and China Investment Corporation (CIC). The former manages the official reserves, while the latter is a sovereign wealth fund seeded from official reserves. It is unlikely that their operations contribute to portfolio outflows.

Graph 5
China Mainland Portfolio Investment by Destination

Hong Kong is a conduit rather than the ultimate destination



* Includes the British Virgin Islands; ** Japan, Australia, Korea, Taiwan and ASEAN.
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In short, the portfolio investment data tells us where the money goes, but not who is ultimately behind the flows.

What Are Chinese Banks Doing with All Those "Shadow" Reserves?

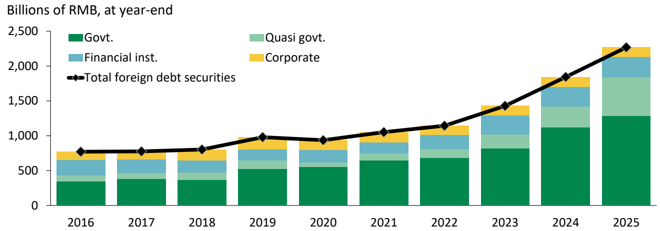
Among China's Big Four state-owned banks, the Bank of China (different from the PBoC) is regarded as the most internationally oriented. It has an extensive overseas network and is considered the market leader in the foreign exchange business.

The Bank of China has quietly accumulated one of the world's largest foreign bond portfolios. Its foreign bond portfolio grew from US$140 billion in 2019 to US$340 billion last year. If it were considered an official institution, it would be the **eleventh largest reserve manager in the world**.

Moreover, the composition of the portfolio resembles that of large reserve managers. Most of it is invested in liquid government securities, with small and stable allocations to riskier debt. Unfortunately, the bank does not disclose the maturity profile, and the other state banks reveal even less. However, Basel III capital and liquidity requirements create strong incentives for these institutions to hold high-quality sovereign securities.

Graph 6
Foreign Bond Holdings of Chinese Banks Have Surged

Bank of China foreign debt securities holdings
Billions of RMB, at year-end



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But Are They Staying in US Dollars?

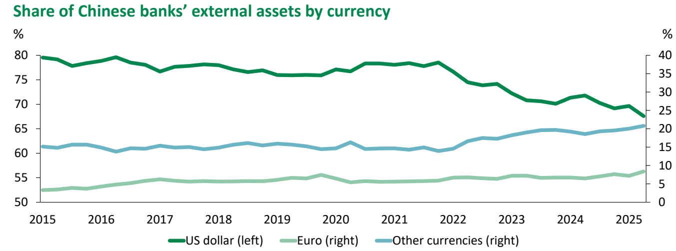
The share of US dollars in Chinese banks' foreign assets has fallen from around 80% in 2022 to 68% this year. This appears to be driven by faster growth in assets denominated in "other currencies" and, to a lesser extent, the euro.

Unfortunately, SAFE does not disclose the composition of "other currencies." But their growing share is consistent with a trend seen across reserve managers globally: diversification away from USD into a broader set of liquid sovereign bond markets. The IMF's COFER data shows global FX reserves in USD have fallen from 62% to 57% since **COVID-19**, most of which has shifted into "other currencies."

We can reasonably infer that the state banks are following a similar diversification strategy. Our best guess is that the "other currencies" bucket includes the AUD, CAD, SGD and HKD, all of which offer high sovereign ratings and deep government bond markets.

Graph 7
Chinese Banks Are Diversifying out of US Dollars

Share of Chinese banks' external assets by currency



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Are They Hedging Interest Rate Risk?

Most reserve managers focus on safety, liquidity, currency composition and, to a lesser extent, yield. They are generally not sensitive to quarterly P&L swings. As such, they typically hold bonds to maturity and tolerate interest-rate volatility.

Chinese state-owned banks operate differently. While they are majority owned by the government, they have private shareholders as well. They are also subject to Basel III capital and liquidity requirements and must actively manage earnings volatility and interest rate risk. The Bank of China explicitly discloses its management of Interest Rate Risk in the Banking Book (IRRBB) and notes that it adjusts the structure of its assets and implements risk hedging to keep interest rate risk within acceptable limits.

The key takeaway for global macro investors is that the shift from reserves to "shadow" reserves isn't a wholesale liquidation of US Treasuries. **It's a shift from a price-insensitive hold-to-maturity buyer to a price-sensitive investor that actively manages duration and interest rate risk.**

What Happened to Banks' Foreign Liabilities?

Banks are not only accumulating foreign assets, they are also paying down external liabilities. The growth in net external assets is coming from both sides of the ledger. The table below breaks this down.

Table
Banks Have Increased External Claims and Reduced External Liabilities

All values in billions of USD	Year		
	2020	2026	Change
External assets	1082	1446	**+364**
Of which:			
- Deposits and loans	759	715	**-44**
- Bonds	164	447	**+283**
External liabilities	892	718	**-174**
Of which:			
- Deposits and loans	538	331	**-207**
- Bonds	88	29	**-58**
Net external assets	**190**	**728**	**+538**

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External liabilities are owed to foreigners.[2] If a Chinese resident deposits a dollar and a foreign depositor withdraws one, the bank's external liabilities fall even though the USD deposits it owes are unchanged.

This helps explain why banks' external liabilities are falling. Chinese banks are so flush with dollar deposits from domestic customers that they have less need for funding from foreign depositors and offshore lenders. For example, the Bank of China pays only 0.8% on a one-year US dollar time deposit and continues to attract funds from Chinese residents.

Why Is China's Foreign Currency Debt Shrinking?

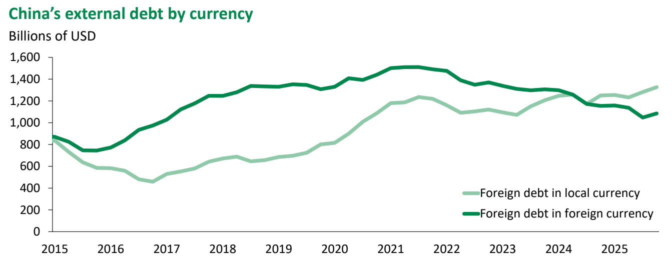
China's foreign currency debt has fallen from US$1.5 trillion in 2021 to roughly US$1.1 trillion this year. Since most of the decline has occurred in the banking sector, we believe it is linked to the trend discussed above: dollar deposits from residents are increasingly replacing foreign funding sources.

At the same time, renminbi-denominated external debt has increased. Chinese corporates have been able to borrow cheaply in the offshore renminbi market, where issuance of so-called "dim sum" bonds has expanded rapidly. The cost of borrowing in RMB is significantly less than borrowing in USD. This market has seen explosive growth. Outstanding dim sum bonds reached roughly RMB1.6 trillion (US$230 billion) at the end of last year, up about 60% from three years earlier.

The net effect is that **it makes China's external balance sheet stronger**. Chinese banks owe less to foreigners while building up claims on the rest of the world. Meanwhile Chinese firms are increasingly accessing international capital markets in renminbi, allowing them to transfer exchange rate risk to overseas investors.

This is the opposite of the situation China was in just 10 years ago. In 2016 there was a run on the renminbi because China's property developers had borrowed too much from foreigners. Now China Inc. is becoming a major net lender to the world. **The pain trade is for the RMB to rise, not fall.**

Graph 8
China's External Debt Is Shifting from USD to RMB



PBoC and Desjardins Economic Studies

Can You Sum It All Up?

Prior to COVID-19, the Chinese central bank absorbed excess US dollars to prevent the RMB from appreciating. These reserves were then recycled into global financial markets, particularly US Treasuries, through SAFE.

China's current account surplus has surged in the post-pandemic period. The RMB remains heavily managed, but the evidence suggests that authorities have increasingly outsourced the intervention and reserve management function to the large state-owned banks. Under the new system, banks are accumulating foreign assets and doing what most reserve managers have done: **staying mainly in government bonds and gradually diversifying out of US dollars**.

[2] SAFE complies with IMF BPM6 reporting standards for this dataset.

The key implication for global bond markets is that unlike traditional reserve managers, **banks actively manage their interest rate exposure**. They are still recycling surplus dollars into foreign bonds, but they are hedging at least part of the duration risk.

Finally, the scale of the covert intervention suggests that the **RMB remains significantly undervalued** despite its recent appreciation.