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Beijing Diversifies Away From U.S. Dollar

By TOM ORLIK and BOB DAVIS



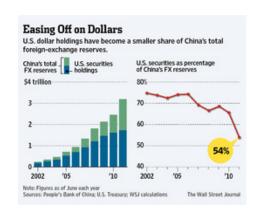
China is shifting sharply away from U.S. dollars and the world hasn't ended-yet. Tom Orlik discusses on Markets Hub. Photo: Ed Jones/AFP/Getty Images.

BEIJING—Fresh data suggest China is moderating its appetite for investing in U.S. securities, a trend that could mean lower flows of cheap capital from Beijing and a possible rise in borrowing costs across the American economy.

An analysis of U.S. Treasury data suggests China, with \$3.2 trillion in foreign-exchange reserves, has begun to rapidly diversify its currencies portfolio.

"It clearly indicates China's intention not to put all its eggs in one basket," said Lu Feng, director of Peking University's China Macroeconomic Research Center.

China still remains a strong buyer of U.S. debt. China's holdings of U.S. securities rose 7% to \$1.73 trillion as of June 30, an increase of \$115 billion from 12 months earlier, Treasury data show.



But the percentage of dollar holdings in China's foreign-exchange reserves fell to a decade low of 54% in the year that ended June 30, from 65% in 2010. The Treasury data provided the most comprehensive read on China's holdings of U.S. securities available.

A comparison with China's own foreign-exchange reserve data suggests a marked reduction in the share of reserves parked in dollars. But difficulties in measuring China's holdings, exacerbated by what some analysts call an attempt by Beijing to hide the allocation of its reserves, mean that it is possible the data overstate the trend.

The purchase of U.S. securities amounted to just 15% of the increase in China's foreign-exchange reserves in the 12 months ended June 30, down from 45% in 2010 and an average of 63% over the past five years, according to calculations based on information published by the U.S. Treasury and the Chinese government.

Economists have long warned that if China starts to cut back its purchases of U.S. securities, U.S. interest rates could climb, damaging the American economy and ratcheting up the government's borrowing costs.

"We've been worried about China refraining from buying U.S. debt for three years now, and it really has not occurred," said David Ader, head of government bond strategy at CRT Capital in Stamford, Conn.

China's foreign-exchange reserves have ballooned over the past two years, and the country has plenty of money to support the U.S. and other debt issuers. "China has been diversifying for several years," Mr. Ader said. "It's been incremental and they've told us that much. Simply diversifying into another currency certainly made sense."

Some economists said China's move was well-timed. "It would be optimal for China to adopt a contrarian strategy and pick times when the dollar is strong to aggressively diversify the currency composition of its reserve portfolio away from the dollar," said Eswar Prasad, a China scholar at the Brookings Institution.

China won't say how it invests its foreign-exchange reserves, which have grown rapidly over the past decade. Beijing has used its control over the exchange rate as a key plank of its economic-development strategy and has racked up immense trade surpluses. That requires China's State Administration of Foreign Exchange to invest the proceeds overseas. In the past, SAFE has hinted that about two-thirds of its stash is held in U.S. securities, a percentage that generally has been in line with annual data collected by the U.S. Treasury. Officials at China's foreign-exchange agency didn't respond to questions faxed to them on Thursday.

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China's leaders have made increasingly strong statements that they would like to help the 17-nation euro zone deal with its troubles. In February, Premier Wen Jiabao, speaking at the EU-China summit, said "Europe is a main investment destination for China to diversify its foreign-exchange reserves."

Klaus Regling, the chief executive of the European Financial Stability Facility—the euro-zone's rescue fund for Greece and other financially troubled nations—was in Beijing in October for

talks with SAFE. Regular talks have continued since then and EFSF documents show that Asia, apart from Japan—essentially China—accounted for between 14% and 24% of purchases for three EFSF bond sales worth €13 billion in the first half of 2011. That was before Mr. Regling's Beijing trip.

China has many reasons to try to reduce its exposure to the dollar. They include very low yields paid by Treasurys and a vulnerability to U.S. decisions on managing its debt, which could lead to inflation that would erode the value of those holdings. Last summer's political debate over raising the U.S. debt ceiling sparked worries that the U.S. could default on obligations.

China also would have good reason for deepening its ties to other currencies. Buying some undervalued European assets during the debt crisis over the past year might have been a smart move. And China has an interest in supporting its exports by helping bolster the currencies of its biggest customers.

Meantime, overall global demand for U.S. securities has remained strong as investors seek a haven during troubled times. Foreign holdings of U.S. securities increased \$1.8 trillion, or about 17%, to \$12.52 trillion over 12 months to June, according to the Treasury data.

To arrive at the percentage of dollar holdings in China's reserves, U.S. Treasury data on Chinese purchases of U.S. securities must be compared with Beijing data on its foreign-exchange holdings. That calculation is complicated by the impact of currency movements on the value of China's reserves. Even so, it is clear that China is purchasing fewer dollar-based securities than it had in the past.

While China's holdings of U.S. securities rose 7% in the year that ended in June, China's total foreign-exchange holdings increased by 30% to \$3.2 trillion, an increase of \$743 billion. Essentially, the pace of China's purchases of U.S. securities didn't come close to matching the pace of expansion of its foreign-reserve pile, reducing the percentage of dollar holdings.



Monthly figures on China's holdings of U.S. Treasurys have been seen as less reliable than the annual survey.

But the Treasury has now introduced a new survey technique intended to improve the accuracy of the data.

The latest monthly numbers show China's holdings of U.S. Treasurys dropped to \$1.15 trillion in December, falling \$156 billion since the period covered by the annual survey. That suggests China's diversification away from dollars may have continued in the second half of 2011.

It is also unclear how much of Chinese dollar holdings are reflected in the latest data. China could have dollarbased assets outside the U.S., held by fund managers in other countries or on deposit in the international banking system.

Where China has pulled back on U.S. securities purchases, others have stepped up. Japan has more than compensated for the difference and other investors in the U.S. and abroad have done the same. That has supported Treasury prices and largely kept the 10-year yield below 2%—lower than it was last summer before any pullback from China.

—Sudeep Reddy contributed to this article.

Write to Tom Orlik at Thomas.orlik@wsj.com

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