Asian Central Banks Consider Alternatives to Big Dollar Holdings

By PHILLIP DAY and HAE WON CHOI Staff Reporters of THE WALL STREET JOURNAL

A number of Asian central banks, among the biggest investors in U.S. government debt, are looking at alternative targets for their vast dollar holdings.

South Korea, looking for better returns, plans to hand over as much as $20 billion of its foreign-exchange reserves, which total the equivalent of $157 billion, to private fund managers next year. Taiwan wants to put some of its $200 billion of reserves toward helping local companies and diversifying the economy. Thailand will use $7 billion of reserves to pay off the foreign debts of its government agencies and state enterprises.

It isn't clear that Asian central banks will necessarily fund these plans by switching out of holdings of U.S. government debt. Asia's bigger central banks have estimated holdings totaling nearly $1 trillion of U.S. government bonds, including Treasurys, privately held government bonds and debt of government-sponsored agencies, such as mortgage buyer Fannie Mae (See related article[1]). Inflows from Asia into this U.S. debt have provided vital support for the U.S. financial system. They have helped to finance the budget deficit and made it easier for the Federal Reserve to boost the economy by holding down interest rates. Foreign buying of debt is "critical -- it's probably the biggest driver" of the Treasury market recently, says Michael Ryan, a strategist with UBS in New York.

The percentage of U.S. government debt owned by foreigners stood at 37.3% last year, compared with 33.9% in 2002 and less than 4.7% in 1965. Foreign central banks hold more than $800 billion in Treasurys -- $1 of every $5 the U.S. government owes. Asia's bigger central banks face a difficult task. They want to reduce dollar risk and shift reserves to better returns, but they have to trim dollar holdings without spooking the U.S. debt market or currency markets -- and potentially fueling the dollar's downward momentum. That in turn would undercut another goal of Asian governments: to slow the rise of their currencies against the dollar, which makes their exports more expensive and threatens Asian jobs.

Although Bush administration and Federal Reserve officials acknowledge that the rest of the world won't lend ever-increasing amounts of money to the U.S. forever, they insist they don't see any imminent threat of a crisis. "Reliance on borrowed funds may not be sustainable," Fed Chairman Alan Greenspan said in a speech last month, but then added that "there is, for the moment, little evidence of stress." The dollar's declining value is a sign of waning foreign appetite for dollar-denominated assets, he said, "yet inflation, the typical symptom of a weak currency, appears quiescent."

Asian central banks lost tens of billions of dollars defending their currencies in the 1997 financial crisis, and since then they have squirreled away as many dollars as they can. Their reserves have grown rapidly from export earnings and, more recently, continual dollar-buying sprees to shore up the falling U.S. currency. In 2003 alone, the foreign reserves held by Asian central banks grew by a third to $1.9 trillion. Critics warn that the Asian banks, in looking to shed some of their U.S. dollar reserves, may be forgetting a key lesson of that crisis. "Foreign reserves are needed to absorb any unexpected external shock," said Rhee Yeung Kyun, director-general of the international department at South Korea's central bank. "There is no such thing as too much foreign reserves."

But for the banks, more-pressing issues outweigh fears of another global shock. Reducing their piles of dollars would cut exposure to eroding dollar values and might also win better returns if the money is invested in currencies that are appreciating. Moreover, holding all those dollars is getting expensive. When the banks trade their national currencies for dollars in the foreign-exchange markets, they issue bonds so the local currency doesn't flood the financial system and cause inflation; investors buy the bonds with local currency, taking it out of circulation. But the central banks have to pay interest on those bonds -- usually at a higher rate than the return they are getting for their U.S. Treasurys.

"Continued accumulation of large amounts of foreign reserves has significant opportunity costs," warned the Asian Development Bank in a December report. "There might be merit for countries in the region to take a fresh look at management of reserves and foreign-exchange policies," the bank concluded.

So far, the two biggest foreign holders of Treasurys, Japan and China, have taken only tentative steps in shifting reserves. Some data suggest that China late last year was putting a lower percentage of its reserves into Treasurys -- although U.S. Treasury data show China's actual holdings rising in October and November. Beijing plans to use about $85 billion of its Treasurys to recapitalize state banks, but ownership of the bonds will simply move from the government's books to the banks' and can't be cashed out.

Last week, responding to questions on the losses Japan has suffered on some of its reserves as the dollar has fallen, Japanese Finance Minister Sadakazu Tanigaki told a parliamentary committee that he will consider diversifying the nation's reserves. Mr. Tanigaki refused to specify whether the country would shift some of its reserves out of Treasurys.

Elsewhere in Asia in recent weeks, however, some governments have begun discussing plans to chip away at their dollar mountains. The initial amounts are small, but taken together they send a clear signal.

South Korea's plans are the most ambitious and could have the biggest impact on the dollar. Next year

Seoul will hand over between $10 billion and $20 billion of its $157 billion in reserves to foreign asset-management firms. "Korea needs to invest its foreign-currency resources more effectively," says Choi Joong Kyung, director-general of the international finance bureau at the finance ministry.

The ministry is establishing the Korea Investment Corp., and expects to fund it with at least $100 billion by 2012. Much of that money will be consigned to foreign investment firms to manage from offices in Seoul, thereby boosting the capital's efforts to become a financial center.

In Taiwan, the current system for managing the nation's $206.63 billion in reserves, the third-largest in the world, "might not be an efficient use of our resources," says government minister Hu Sheng-cheng. Taiwan's central bank has accumulated "too much" foreign exchange from Taiwanese exporters and from inflows to its capital markets, he says.

Mr. Hu is heading a task force that will announce in the next few weeks details of a plan to use reserves to help local companies buy machinery and intellectual-property rights overseas, he says.

The initial aid probably will go toward companies involved in biotechnology, which the government is promoting as a way to diversify its economy, or making flat-screen displays, according to local news accounts. Mr. Hu declined to discuss the details of the plan.

It is unclear whether such plans, which imply feeding dollars back into the international economy, could have a negative effect on the dollar.

Thailand's central bank wants to put some of its dollar reserves toward ridding other parts of the government of dollar debt. Thailand has been steadily reducing its foreign debt. It paid off the last of the $12 billion it borrowed from the IMF during the financial crisis ahead of schedule last July.

Now Thailand plans to use $7 billion of its $43 billion in reserves to pay off the debts of state agencies -- $16.7 billion by the end of the third quarter last year -- during the next three years.

-- Michael S. Derby in New York