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- [Markets & funds data](#)
- [Industries](#)
- **Lex**
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### Lex live: Central Bank Reserves

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Drip by drip, the diversification of central bank reserves away from US assets is becoming a reality. A survey by Central Banking Publications, of 65 central banks with up to \$250bn each under management, shows an increase in exposure to the euro over the last two years, mainly at the expense of the US dollar.

Unfortunately, the vital question of Chinese intentions remains unanswered. While the survey is anonymous, it clearly does not include the People's Bank of China or the Bank of Japan, which each controls more than \$250bn of official reserves.

Recent evidence shows no let-up in the pace of Chinese reserve accumulation. Reserves increased by 50 per cent in 2004 to reach \$610bn, with China overtaking Japan as last year's biggest accumulator.

Diversification of these reserves, currently predominantly held in dollars, will probably be a gradual process. The Chinese have a vested financial interest in avoiding a disorderly dollar decline. Shifting part of reserve growth, rather than existing holdings, out of dollars is the most likely outcome.

A renminbi revaluation remains a possibility, which would reduce the need to buy dollars. China has begun to tighten domestic monetary policy and unsterilised currency intervention conflicts with this objective. Meanwhile, European officials have become more vocal in their efforts to get China to accept a weaker dollar ahead of February's G7 meeting. A step change in the currency would not, however, put an end to reserve accumulation. China's current account surplus with the US would not adjust immediately and substantial purchases to cover trade flows would remain.

Chinese reserve accumulation last year was equivalent to almost a third of the US current account deficit. A sudden withdrawal of Chinese support appears unlikely. But, as Alan Greenspan, Federal Reserve chairman, warned in November, there is a limit to the willingness of foreign governments to finance the US deficit.


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