Talk in Japan Shakes Dollar and Treasuries

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The dollar fell and Treasury yields rose yesterday after the Japanese prime minister made remarks that suggested the country's central bank could be shifting some of its huge reserves out of dollars and Treasury securities.

Japan's Ministry of Finance quickly denied there was any change, a statement that limited the fall of the dollar and bolstered Treasury prices. But the volatile reactions in the markets underscore that the dollar, already under pressure from the drag of the United States' record current-account deficit, has another issue that could weigh on it in the future.

"There is a heightened sensitivity to anything that smacks of reserve reallocation," said Robert Sinche, global head of currency strategy at Bank of America.

Indeed, the comments from the prime minister, Junichiro Koizumi, came less than a month after reports, later denied, that the central bank of South Korea was planning to move some of its reserve holdings out of dollars and into other currencies. Even after the denial, those reports roiled the currency markets, and the dollar fell 1.5 percent against the euro and 1.4 percent against the yen on Feb. 22.

Yesterday, the dollar slipped as much as 0.4 percent against the euro and 0.1 percent against the yen. Late in trading, the euro was valued at $1.3424, with the dollar down 0.1 percent, and the dollar was up 0.2 percent against the yen, at 104.02 yen. The yield on the 10-year Treasury note, which jumped to 4.56 percent, finished the day at 4.50 percent, down from 4.52 percent on Wednesday.

The suggestion of diversification from dollars has put the focus on the role of Asian central banks in the performance of the dollar and Treasury securities.

China, Japan, Hong Kong, South Korea and Taiwan together hold 56 percent of the Treasury securities owned by foreigners. Many of those securities are held by their central banks. So any significant shift of their reserves out of dollars could spell trouble for both the American currency and the bond market.

Steven Englander, chief foreign exchange strategist for the Americas at Barclays Capital, said he did not expect such a shift "in a dramatic way" by these Asian central banks. But, he said, "everyone is thinking about it and that will weigh on the foreign exchange and bond markets."

Alan Greenspan, the chairman of the Federal Reserve, has said a shift out of dollars by foreign central banks and foreign private investors should be expected at some time, although he has not said it would necessarily be disruptive.

In a speech to the Council on Foreign Relations yesterday, Mr. Greenspan said that official and private foreign investors "will at some point choose greater balance in their asset accumulation."

Another emerging issue is what happens when China, which is being pressured by the United States and other countries to allow its currency to trade freely, moves away from pegging the yuan to the dollar.

To maintain the present peg, China has to sell yuan for dollars as the American currency weakens, building up huge dollar reserves, most of which are invested in Treasuries. Other Asian countries, including Japan and South Korea, have done the same so that their currencies stay competitive with the yuan.

Many analysts expect a small move toward delinking in the next 12 months that would allow for an increase of 3 percent to 5 percent in the value of the yuan. This could mean that China and other Asian countries would have less need to build up dollar reserves and, therefore, less need to invest in United States Treasury securities.

If this led to lower dollar reserves and a decline in central bank investments in the Treasury market, some analysts argue that the impact on the American market would depend on how attractive it would be at that time to invest in the United States.

If inflation was contained, economic growth was steady and the current-account and federal budget deficits were improving, attracting private money to replace a slowdown in investment by central banks would not be difficult. That would reduce any downward pressure on the dollar and upward pressure on Treasury yields.

Mr. Englander said that "a lot depends on how China delinks."

"The odds are it's going to be a mini-delink, rather than a maxi-delink," he said, which would minimize the impact on the dollar and the Treasury market.

Others argue that central banks would not want to do anything precipitous because that would be bad for global financial markets and could hurt the competitiveness of their own currencies.

"They don't want to disrupt the markets," said William Davison, head of the Hartford's fixed-income mutual funds.

Mr. Sinche at Bank of America said it was in China's interest to move slowly in ending the yuan's link to the dollar, and that would mean that any other central banks in Asia that want to shift reserves out of the dollar would have to move slowly.

Mr. Sinche also played down Mr. Koizumi's remarks as an indication of a new plan for reserves.

He said the comments, which were made before a parliamentary committee, were not an answer to a question on whether central bank reserves should be shifted, but regarded what should be done about the unrealized loss Japan's central bank has on its reserves. Since the loss is a result of a decline in the value of the dollar, an obvious political answer is to mention moving reserves out of dollars.

Mr. Koizumi told Japanese lawmakers that as a general rule "it's necessary to diversify the investment destinations," according to Bloomberg News. He added that he also believed it was important to consider "what's profitable and what's stable" when deciding where to hold foreign reserves.

Finance Ministry officials responded quickly to counter Mr. Koizumi's remarks, saying they had no plans to shift the reserves into other currencies. "At present, we have no plans to change the currency makeup" of Japan's foreign exchange reserves, Koichi Hosokawa, a vice minister of finance, told reporters.

Kamal Sharma, senior currency strategist at Dresdner Kleinwort Wasserstein in London, said, "I personally don't believe we'll ever get to a point where Asian central banks will not hold the dollar as the major international reserve currency."

Todd Zaun contributed reporting from Tokyo for this article.

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