COUNCIL on FOREIGN RELATIONS

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Quarterly Update: BRIC Financial Holdings —Retreat from the Dollar?

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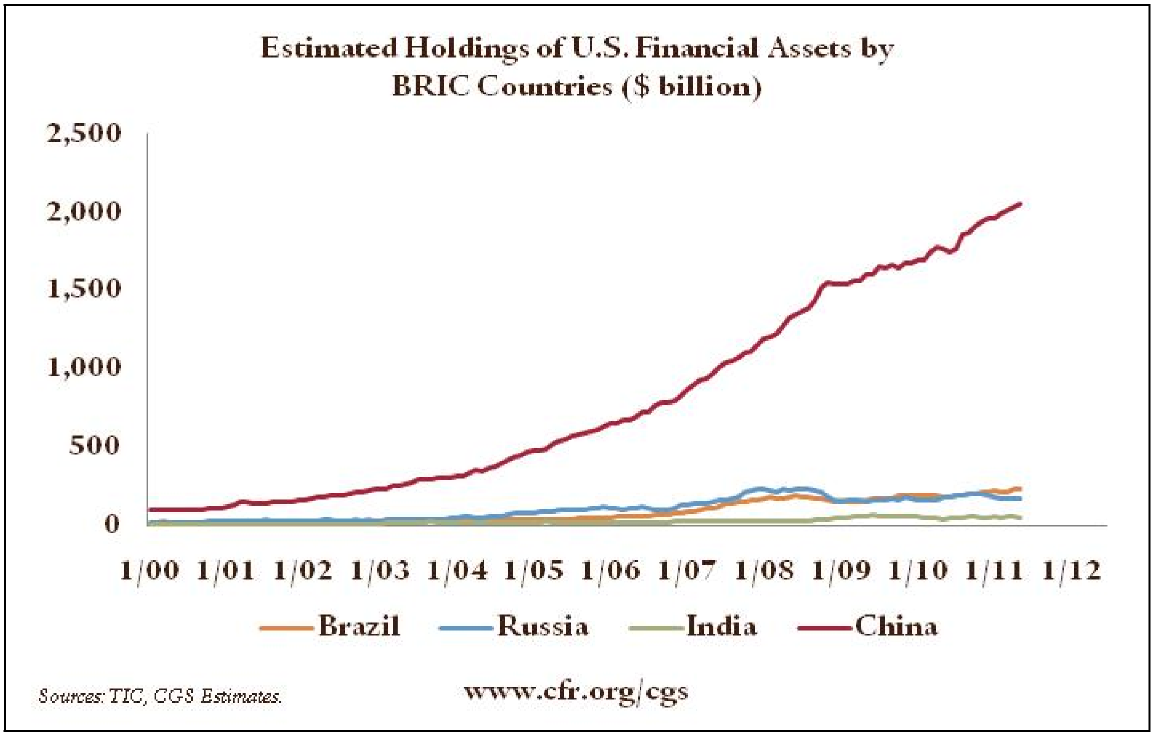
Responding to the recent downgrading of the U.S. credit rating, China gave warning that "The U.S. government has to come to terms with the painful fact that the good old days when it could just borrow its way out of messes of its own making are finally gone." As the following charts show, this warning is significant because the United States borrows heavily from China and other BRIC governments— Brazil, Russia, and India. Five points stand out:

- Both the level and growth of China's reserves dwarf those of the other BRIC countries. Chinese reserve accumulation over the past twelve months exceed Brazil's, Russia's, and India's stocks of reserves.
- Reserve growth slowed during the crisis for all of the BRICs; for Brazil and China it is approaching pre-crisis growth levels.
- Risky U.S. assets remain out of favor. During and after the financial crisis, the BRICs sought refuge in low-risk U.S. treasuries; they are sticking to this pattern now.
- The shift towards low-risk assets has not resulted in a shift toward U.S. assets, as might have been expected. Brazil, which invested its reserves nearly exclusively in dollar assets before the crisis, provides the clearest example of how reserve managers are diversifying away from the greenback, following Russia's diversification in 2006.
- Reserve growth is a byproduct of currency intervention, but its implications vary across countries. In China's case, reserve growth helps maintain an undervalued currency and hence a large current-account surplus, fueling the imbalances that destabilize the global economy (see the Geo-Graphics Blog post "China's Imbalances Are Bigger Than Reckoned"). In Brazil's case, reserve growth helps contain its current account deficit in the face of strong investment inflows that threaten an overvaluation of the Brazilian real; thus Brazil's reserve accumulation arguably serves to reduce imbalances, though intervention that holds a currency below its market price may stimulate additional inflows of hot money in anticipation of appreciation, and may boost inflation.

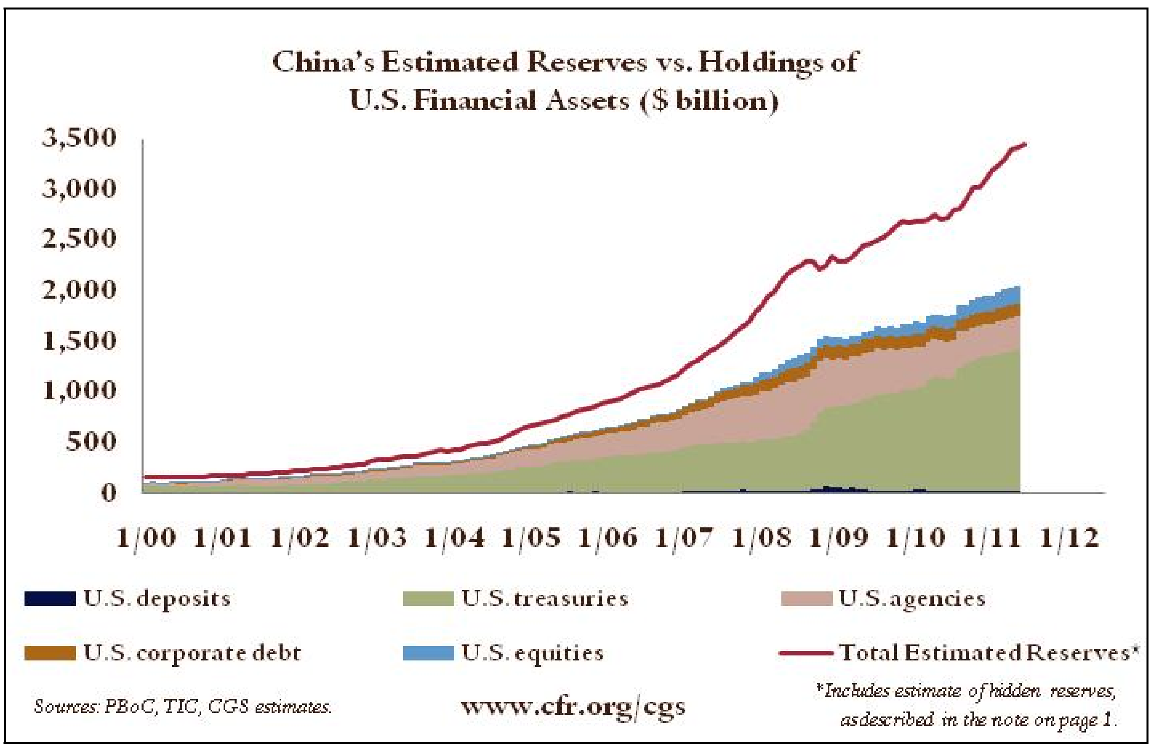
For a broader picture of foreign capital flows into the United States, please see our companion Chart Book here.

A note on methodology: These charts are derived from reserve data produced by the BRIC central banks, from capital flows data produced by the U.S. Treasury in its International Capital System series (TIC), from the International Monetary Fund's (IMF) Currency Composition of Official Foreign Exchange Reserves (COFER), and from Greenberg Center for Geoeconomic Studies estimates. China's reserves data have been adjusted to include China's hidden reserves, which include an amount listed on the balance sheet of the People's Bank of China under the heading "other foreign assets," and an estimate of foreign assets held at the China Investment Corporation (China's sovereign wealth fund). The U.S. TIC data have been adjusted to include purchases made through London and Hong Kong. These adjustments anticipate revisions that are likely to be made when the Treasury's annual survey is published; by looking at the pattern of past revisions, it is possible to estimate future ones. Unless otherwise noted, foreign asset growth or reserve growth has not been adjusted for valuation changes due to currency moves.

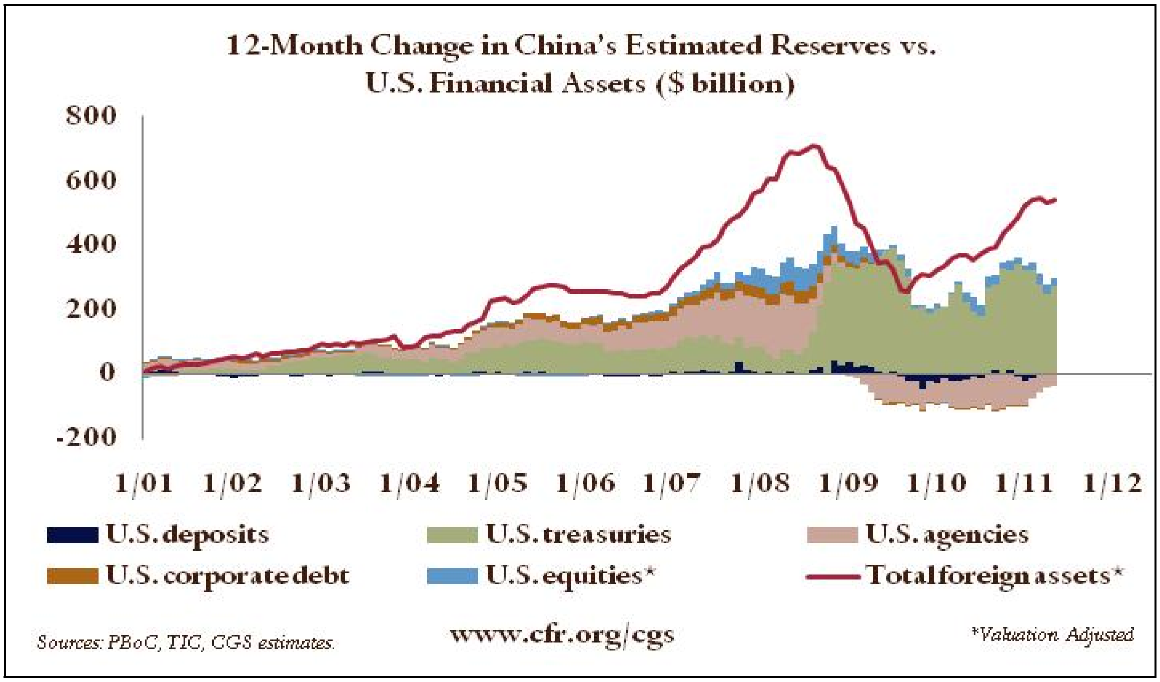
There is much talk about the BRIC countries as a group, but when it comes to financing the United States, China stands apart.



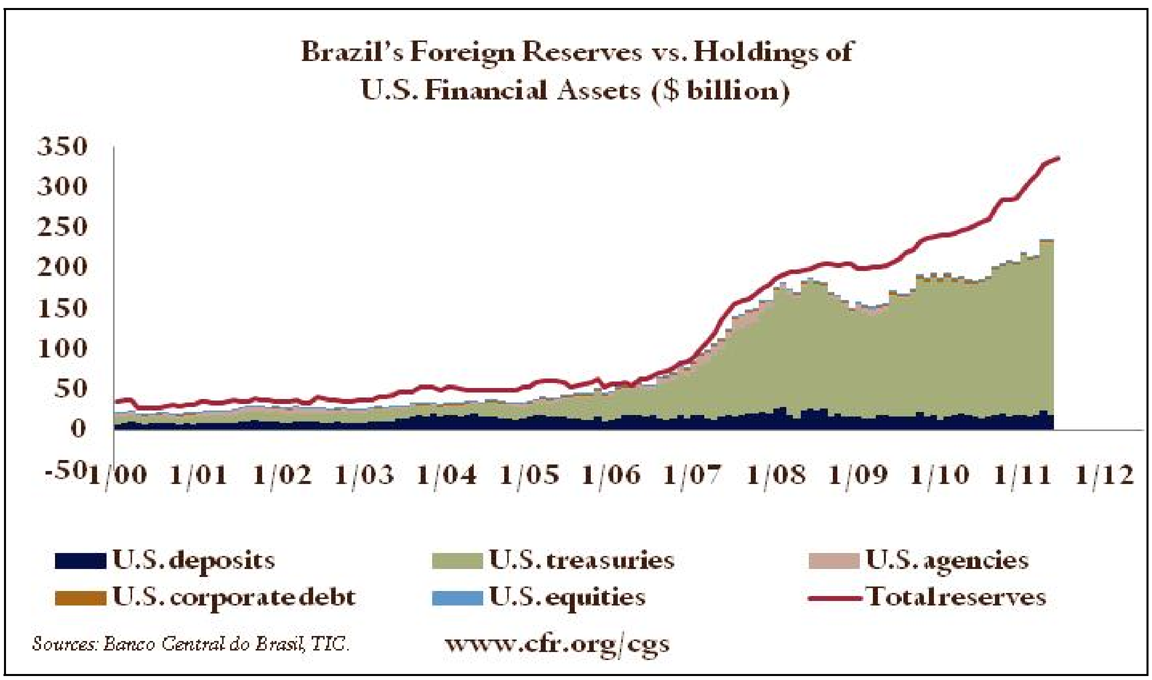
Chinese concern about the weakness of the U.S. dollar stems from the fact that the majority of the government's foreign assets are composed of dollar assets. However, the dollar share is falling. It stood at over 71 percent of the total in January 2005 but is only 60 percent now.



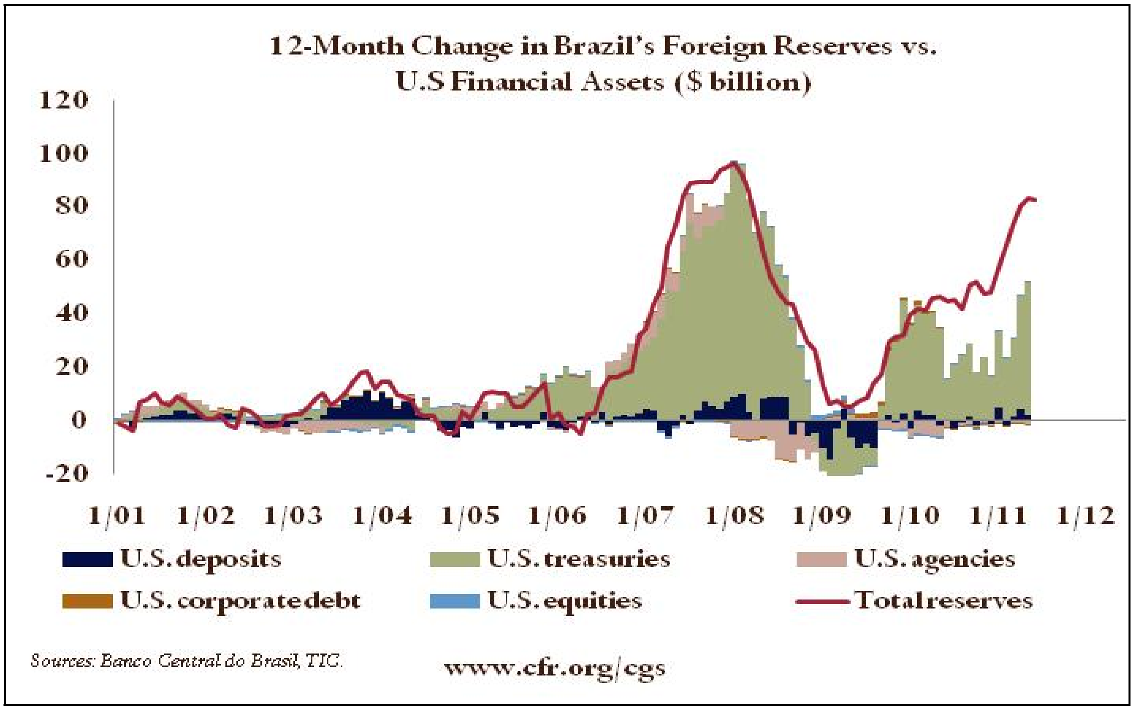
China's foreign assets grew at a slower rate during the crisis, but growth was still rapid and has accelerated of late. The bulk of the U.S. assets purchased by China are treasuries, unlike before the crisis, when Chinese official purchasers bought agencies, equities, and corporate debt.



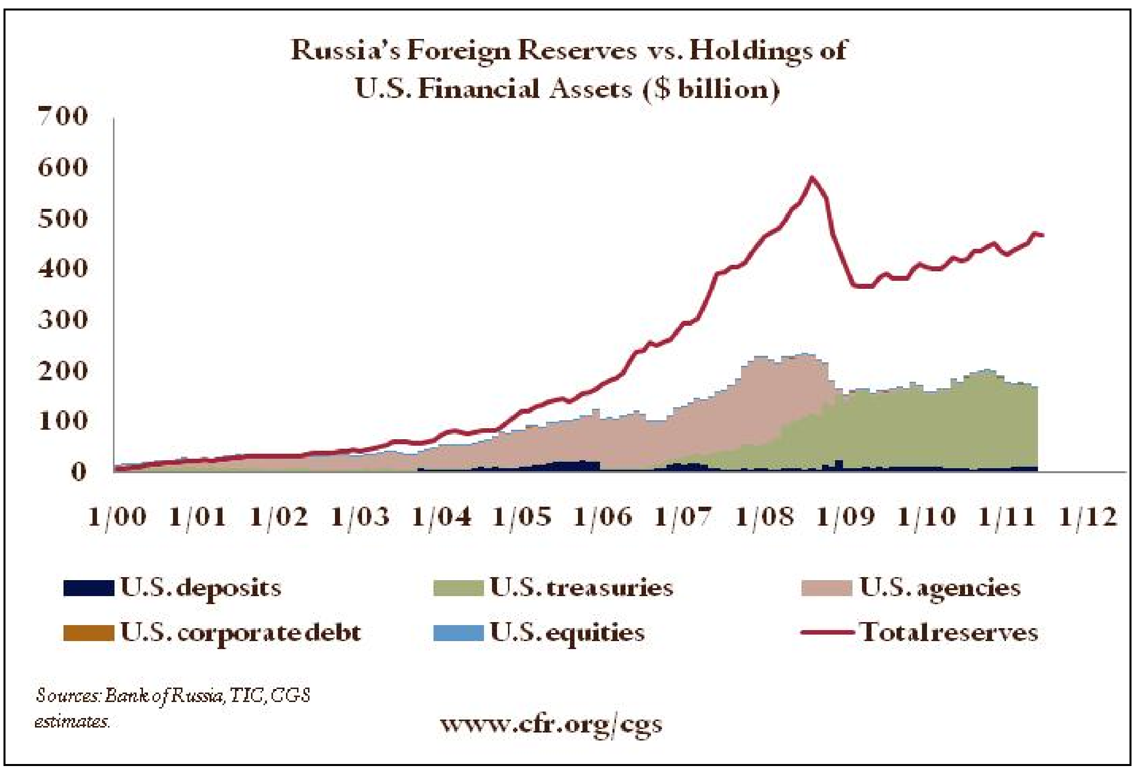
Brazil continues to keep most of its reserves in U.S. treasuries. Its holdings of U.S. corporate debt and U.S. equities are so small as to be virtually invisible in the picture. Before the crisis, Brazil's reserves were almost exclusively in U.S. financial assets. That share had fallen to 71 percent in May 2011.



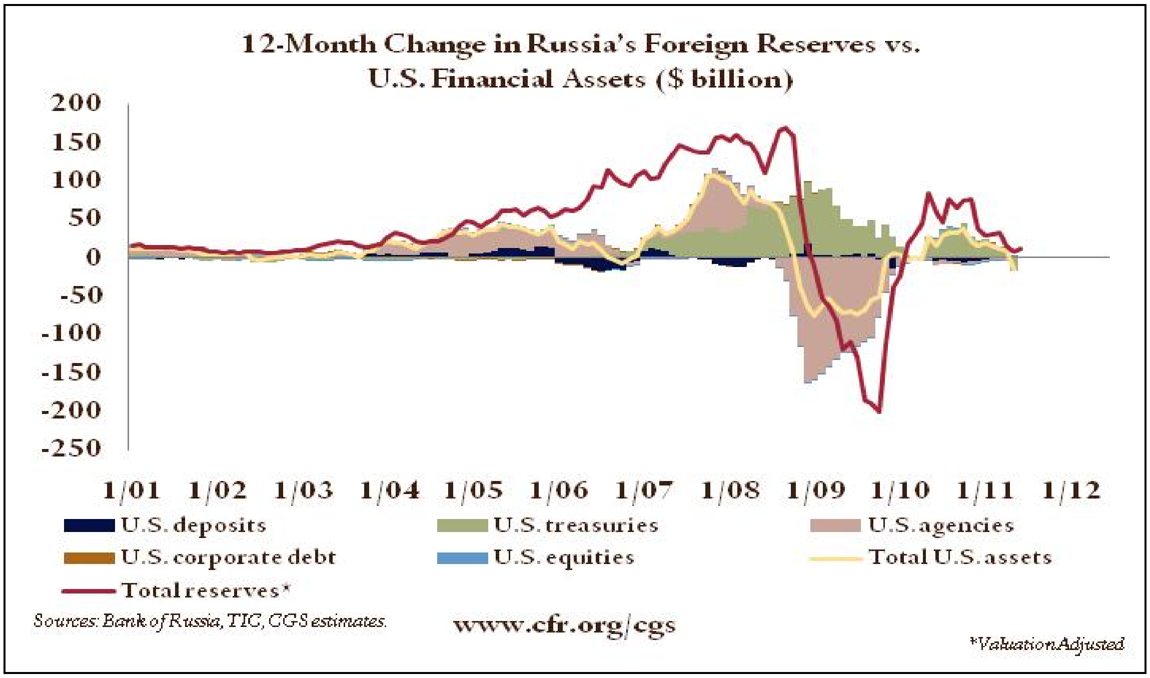
In the midst of the crisis, when reserve growth was flat, Brazil diversified its reserves away from the dollar by selling dollar assets. As reserve growth resumed, so did the accumulation of dollar assets. But recent reserve growth has been much stronger than dollar asset accumulation, despite a recent increase in Treasury-buying.



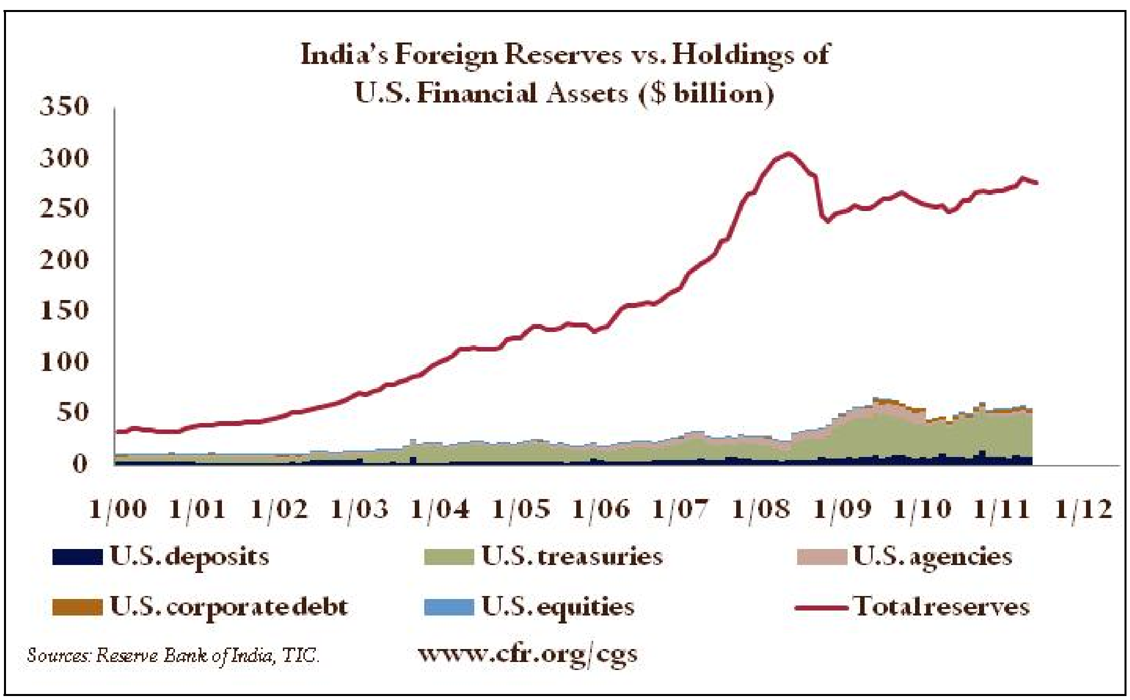
Russia's reserves fell sharply in 2008 and early 2009. By 2010, both total reserves and dollar holdings resumed their upward march. Reflecting its economic proximity to the eurozone, Russia began to move its reserves out of dollars in the mid-2000s; in 2007, the dollar share of reserves averaged 45 percent, down from 70 percent in 2005.

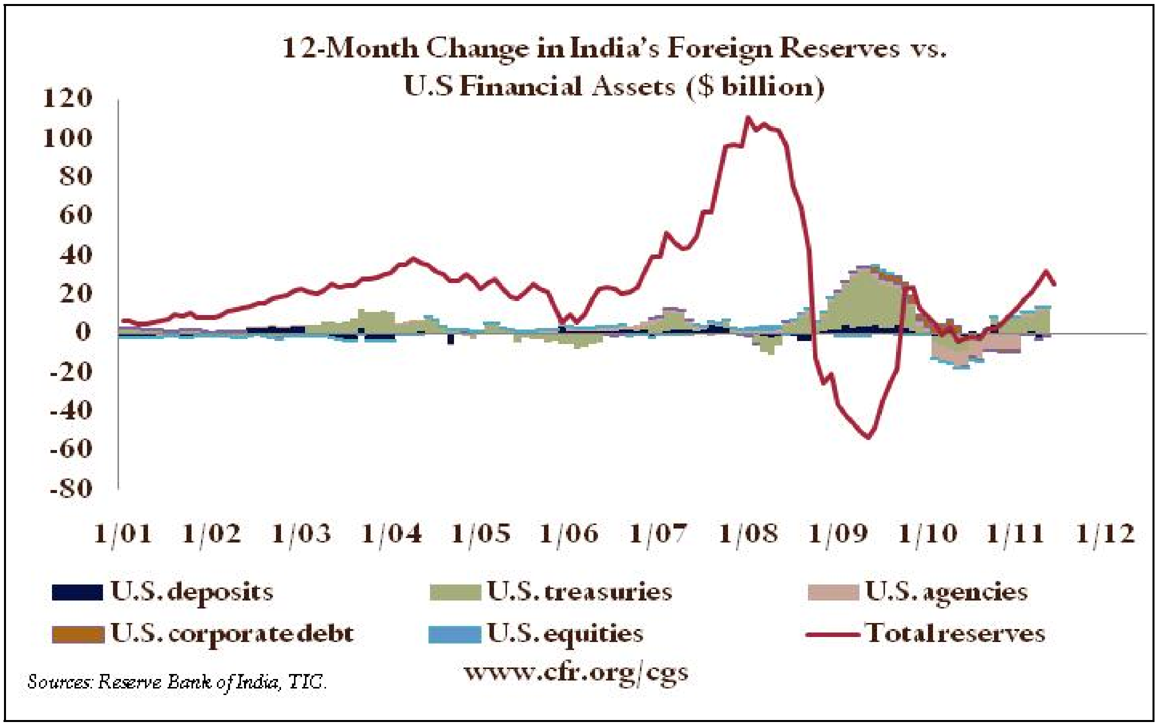


Even as its reserves fell, Russia continued to purchase U.S. treasuries, raising the money by selling all of its agencies. Russia's appetite for treasuries continued after the crisis. Although the level of Russian reserves has increased (chart above) the change has been driven by currency valuation, not purchases of reserves (chart below). Russia holds approximately 55 percent of reserves in nondollar assets and, hence, changes in its reserve levels fluctuate with currency exchange rates.

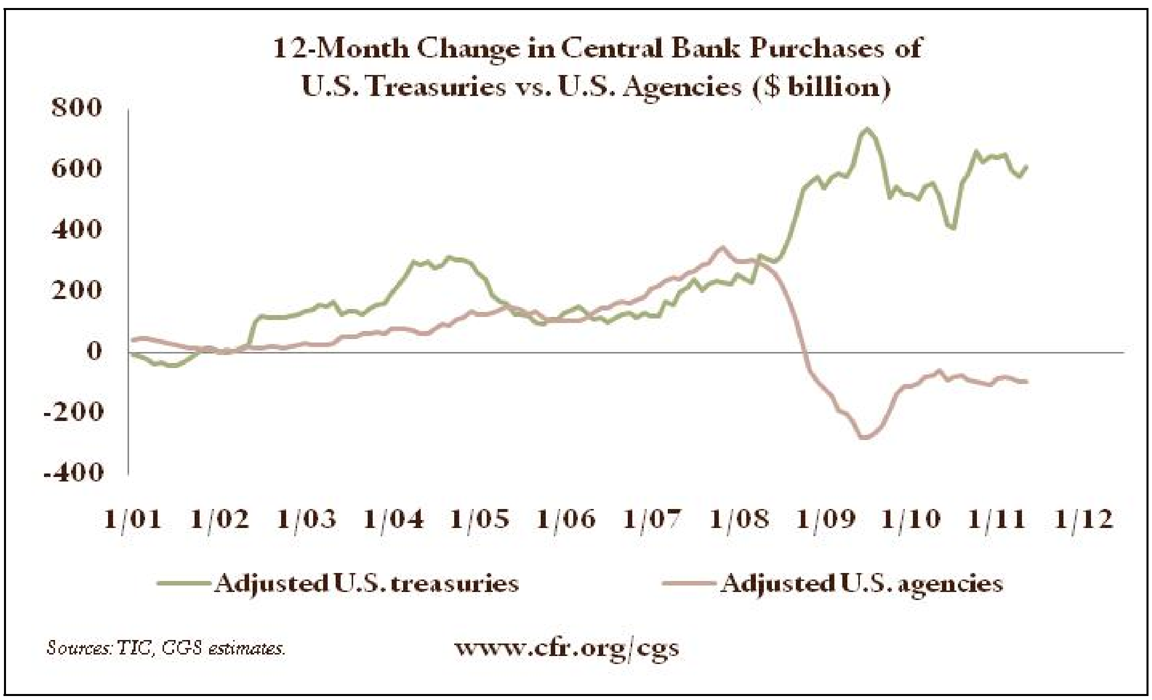


India's reserves are held mostly as bank deposits. A large share is likely held at the Bank for International Settlements. As a result, the U.S. data do not provide much insight into the currency composition of its assets. The white space in the chart below, showing the large gap between reported dollar assets and total reserves, does not reflect large Indian nondollar holdings. However, the small portion that is observable in the U.S. TIC data suggests an increased appetite for U.S. treasuries after the crisis, following the pattern in China, Russia, and elsewhere.



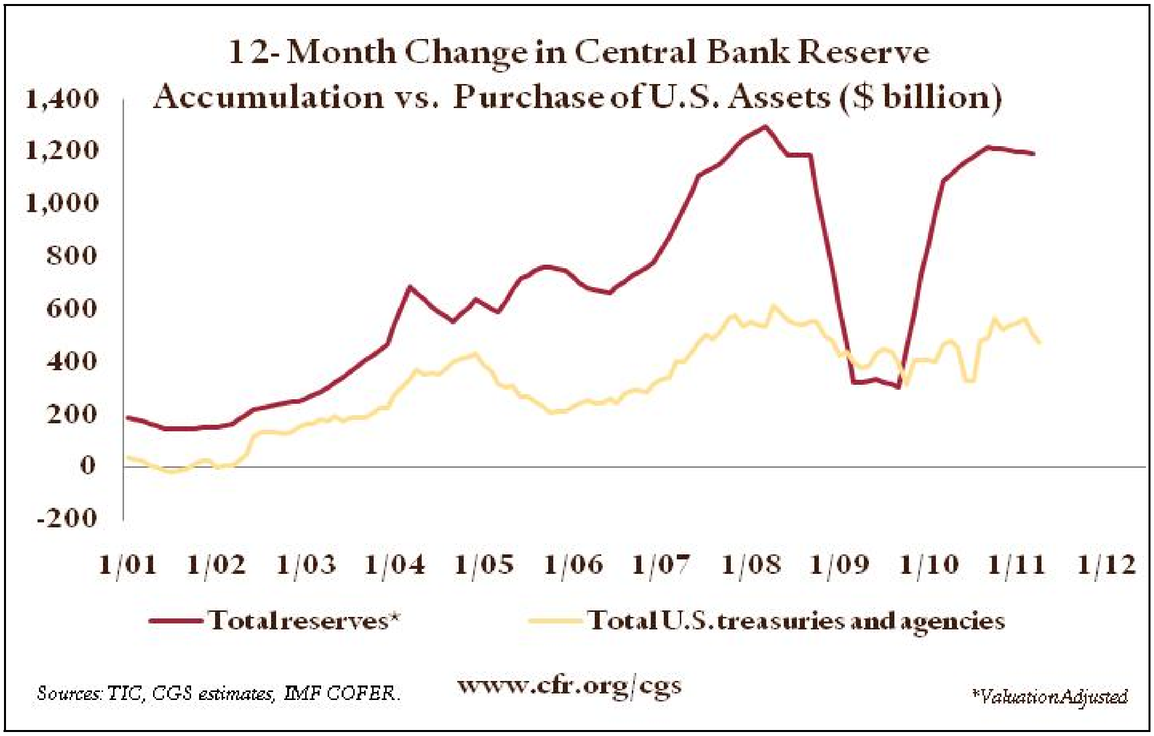


Total central bank (not just BRIC) demand for agency bonds fell sharply in late 2009 while demand for treasuries rose. This pattern persists postcrisis as central banks continue to sell agencies.



Note: These data include all central bank purchases, not just those by the BRIC countries.

Looking at all central bank purchases (not just the BRICs'), the dollar seems to be slipping from favor. Starting in about 2005, the dollar represented a lower share of fresh accumulation than in the past. During the crisis, this pattern reversed itself as reserve managers took refuge in the perceived safety of U.S. treasuries. When the financial crisis ended, the flight to dollars stopped—though sovereign debt worries in Europe still make the dollar look relatively attractive.



Note: Reserves data comes from the IMF's COFER data series. The quarterly data have been adjusted to a monthly series. These data include all central bank purchases, not just those by the BRIC countries.