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FEATURE FOCUS



Japan and China lead flight from the dollar

By Ambrose Evans-Pritchard, International Business Editor
Last Updated: 12:26am BST 18/10/2007

Japan and China led a record withdrawal of foreign funds from the United States in August, heightening fears of a fresh slide in the dollar and a spike in US bond yields.

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Data from the US Treasury showed outflows of \$163bn (£80bn) from all forms of US investments. "These numbers are absolutely stunning," said Marc Ostwald, an economist at Insinger de Beaufort.

Asian investors dumped \$52bn worth of US Treasury bonds alone, led by Japan (\$23bn), China (\$14.2bn) and Taiwan (\$5bn). It is the first time since 1998 that foreigners have, on balance, sold Treasuries.

Mr Ostwald warned that US bond yields could start to rise again unless the outflows reverse quickly. "Woe betide US Treasuries if inflation does not remain benign," he said.

The release comes a day after the IMF warned that the dollar was still overvalued and likely to face "some depreciation in the medium term".

The dollar's short-lived rally over recent days stopped abruptly on the data, increasing pressure on US Treasury Secretary Hank Paulson to shore up Washington's "strong dollar" rhetoric at the G7 summit this week.

The Greenback has already fallen below parity against the Canadian Loonie for the first time since 1976 and has touched record lows against a global basket. It closed at \$2.032 against the pound.

David Woo, an analyst at Barclays Capital, said Washington was happy to see the dollar slide. "They don't care so long as the fall is not disorderly. They see it as a way of correcting the deficit." he said.

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Mr Woo said a chunk of the August outflows may have come from foreigners borrowing in the US during the liquidity crunch to meet needs in euros. "We think it may be a one-off," he said.

The US requires \$70bn a month in capital inflows to cover its current account deficit, but the key sources of finance are drying up one by one.

BNP Paribas said America has relied on "hot money" from abroad to cover 25pc to 30pc of the US short-term credit and commercial paper market over the last two years.

This flow is now in danger after the seizure in parts of the market over the summer and after the Federal Reserve's half point rate cut, which has shaved the US yield advantage over other countries.

Ian Stannard, a Paribas currency analyst, said the data was "extremely negative" for the dollar. "It exceeds the worst fears. It is not just foreigners who are selling US assets. Americans are turning their back as well," he said.

Central banks in Singapore, Korea, Taiwan, and Vietnam have all begun to cut purchases of US bonds, or signalled an intent to do so. In effect, they are giving up trying to hold down their currencies because the policy is starting to set off inflation.

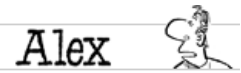
The Treasury data would have been even worse if it had not been for \$60bn of inflows from hedge funds based in Britain and the Caymans, which needed to cover US positions at the height of the credit crunch.



The US requires \$70bn a month in capital inflows to cover its current account deficit

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