NEW YORK, Aug 7 (Reuters) - A decision by Italy's central bank to trim the dollar share of its foreign reserves may be another sign of flagging confidence in the greenback.

But when it comes to currency reserves, it's the developing world -- not the industrialized one -- that matters most.

Russia, China and other countries that hold much larger dollar reserves than Italy are facing growing temptations to adjust their holdings, a possibility that would carry much greater risk for the greenback.

That's because the dollar has steadily lost ground against its main rivals this year, and if that decline accelerates, it would erode the value of those central banks' dollar holdings.

"The real question is not what Italy is doing but what Russia is doing, what Gulf oil exporters are doing with their reserves," said Brad Setser, research director at consulting firm Roubini Global Economics in New York.

The Bank of Italy's $23 billion reserves "are less than that of a small real-money manager," said London-based Morgan Stanley FX strategist Stephen Jen.

He said the Italian central bank's announcement that it had cut its dollar reserves from 84 percent to 63 percent while increasing its sterling holdings is of little consequence.

Most accumulation of the world's estimated $4.5 trillion currency reserves in recent years has been in developing countries. Thanks to sales of oil and cheap consumer goods, reserves in Russia, China and the Gulf oil states dwarf those held by most Group of Seven advanced economies, save Japan.

That means these countries are the primary creditors filling the $800 billion U.S. current-account deficit.

Unlike Italy, Russia is estimated to hold some $185 billion foreign currency reserves and China a record $941 billion. Clearly, changes to these holdings could spark a much sharper dollar decline. That would push up U.S. interest rates and the cost of servicing the United States' massive debt.

HUNTING FOR FAIR RETURN

Setser said his estimates suggest the world's largest dollar reserve holders did not follow Italy's lead in the second quarter of 2006. Instead, they boosted their purchases of the falling dollar to stabilize it against their currencies and maintain the dollar-euro share of their reserves.

But many strategists say the incentives for emerging-market countries to alter their behavior are rising. Indeed, the U.S. economy is showing signs of fatigue and the dollar has shed nearly 9 percent against the euro since January and 11 percent against sterling.
Markets expect the Federal Reserve to stop raising interest rates soon -- possibly at its meeting on Tuesday -- removing the yield advantage that has until now buoyed the greenback.

A recent International Monetary Fund working paper by Francis Warnock estimated that a 10 percent decline in the exchange value of the dollar and the U.S. bond market would rack up foreign wealth losses that amount to 2.5 percentage points of foreign gross domestic product.

"When you amass dollar-denominated government bonds, you will demand that you get a fair rate of return," said Dimitri Papadimitriou, president of the Levy Institute, a public policy research center in Annandale-on-Hudson, New York.

Of course, central banks, particularly those in emerging markets, don't make reserve decisions based entirely on return, as a private investor would.

In China's case, for instance, buying dollars helps control the yuan's value and supports the country's export-led growth.

But losses on reserves can create political pressure, especially in emerging markets where laws require central banks to publish their books in local currencies, said Bankim Chadha, global head of FX research at Deutsche Bank in New York.

"They're sensitive to booking losses for good reason, because at some point, (the bank) risks its independence," he said.

Both Russia and the United Arab Emirates said this year that they had reduced dollar holdings on the margins in favor of other currencies.

Chadha said a gradual but steady rebalancing of reserves should be consistent with an orderly dollar decline.

Economists say it would even help chip away at the U.S. deficit, as costlier imports would force Americans to save more and spend less.

But there are risks. Chadha said the biggest dollar holders can be likened to a cartel: They can't all move at once lest the dollar fall through the floor.

As with all cartels, the smaller members have more incentive to deviate by acting more quickly on the margins.

"Diversification announcements from smaller oil-exporting or Asian central banks such as the recent one by the UAE are therefore worth watching for," he said.