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China Widening Yuan Band Shows Confidence in Economy

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China's doubling of the yuan trading band signals official confidence in the strength of the economy's expansion and suggests policymaking is unimpeded by the ouster of Bo Xilai from the Communist Party leadership.

The change that takes effect today "adds to my confidence in a soft landing," said Jim O'Neill, who is chairman of Goldman Sachs Asset Management in London and coined the acronym BRIC for Brazil, Russia, India and China.

A more flexible yuan may help central bank Governor Zhou Xiaochuan control inflation and support an economy that the World Bank sees growing 8.2 percent this year. The timing of the move may be intended to mute criticism of Chinese currency policies at International Monetary Fund and Group of 20 meetings and indicates that the scandal engulfing former Chongqing chief Bo, 62, will fail to stall the nation's economic opening up.

"The government is confident that China will avoid a hard landing, otherwise why would they introduce the possibility of greater foreign-exchange volatility?" said Stephen Roach, a professor at Yale University and former non-executive chairman for Morgan Stanley in Asia.

The yuan can move as much as 1 percent against the dollar from a so-called daily fixing rate, after the central bank on April 14 announced the first widening of the band since 2007.

Third-Worst Performer

The Chinese currency is the third-worst performer in Asia against the dollar this year after the Japanese yen and the Indonesian rupiah. Today, the yuan fell 0.18 percent to 6.3145 as of 12:04 p.m. in Shanghai after earlier declining as much as 0.35 percent as the central bank set its fixing lower.

In "the midst of domestic political turmoil, reform-minded officials seem to be sensing a window of opportunity to undertake significant steps towards market-oriented reforms," said Eswar Prasad, a senior fellow at the Brookings Institution in Washington and former head of the China division at the IMF. He saw “a renewed momentum towards currency and financial market reforms.”

Investors, commodity suppliers and foreign companies targeting consumers in the world’s second-biggest economy are focused on the risks from a cooling property market and weakness in exports as European economies impose austerity measures. While growth moderated to 8.1 percent in the first quarter, the least in almost three years, companies are still raising their bets on China, with Apple Inc. (AAPL) planning more investment and Ford Motor Co. (F)’s China unit expanding a plant in Chongqing, the southwestern city formerly run by Bo.

Investor Concern

The central bank’s move indicates “that they are not as concerned as share-market investors are about the prospect of a hard landing,” said Shane Oliver, Sydney-based head of investment strategy at AMP Capital Investors Ltd., which has more than $100 billion under management.

“In 2008, their response to the global financial crisis was to link the yuan back to the dollar,” Oliver said. “Now they are widening the band it shows they are a lot more confident that the big manufacturers down the coast of China won’t be adversely affected.”

An unexpected surge in new loans in March, reported last week, showed that the ruling Communist Party is trying to avoid a deeper growth slide as the nation prepares for a once-a-decade power transfer to younger leaders. That changing of the guard has been marred by the ousting of Bo, who backed a bigger role for the state in the Chongqing economy.

Business Empire

The drama surrounding the Chongqing official became public after his police chief spent a night in a U.S. consulate. Now, state media say Bo’s wife, Gu Kailai, is a suspect in the death of British businessman Neil Heywood in November. Gu’s sisters, meanwhile, controlled a web of businesses from Beijing to Hong Kong to the Caribbean worth at least $126 million, regulatory and corporate filings show.

The handling of the Bo Xilai case, the incident involving the police chief and the Heywood death has nothing to do with a “political struggle,” China’s official Xinhua News Agency said in an unsigned commentary. The decision to investigate Bo and the Heywood death is a “resolute move” by the Communist Party to pursue the rule of law, Xinhua said.

O’Neill said that changes such as the yuan move suggest that “reformers” are driving policy, while Roach said he saw signs that “a resumption of accelerated reforms is gathering momentum,” also citing Premier Wen Jiabao's comments this month on the need to break a banking "monopoly" of a few big lenders that make easy profits.

Capital Controls

The new rules for yuan trading follow increases in quotas for foreigners buying stocks and bonds in China and in the amount of yuan held offshore that can be invested locally. A five-year plan running through 2015 calls for officials to keep loosening controls on capital flows as the nation moves towards a convertible currency.

President Barack Obama's administration says Beijing still keeps the exchange rate artificially weak, hurting American manufacturers and contributing to a U.S. trade deficit with China that rose 8 percent to $295 billion last year.

"While we welcome the progress to date, the process of correcting the misalignment of China's exchange rate remains incomplete, and further progress is needed," a Treasury official said in an e-mailed comment on the widening of the trading band. The Treasury delayed a report on the exchange-rate policies of trading partners including China from April 15 until after global meetings scheduled for the next several weeks.

Trade Flows

A narrowing of China's trade surplus and a swing in February to the nation's biggest monthly deficit since at least 1989 are giving Chinese officials ammunition to counter such arguments. The IMF is set to lower its forecasts for China's medium-term current-account surplus, according to two officials who have seen the draft report.

The IMF in September estimated surpluses of more than 7 percent of gross domestic product for 2015 and 2016. The new forecasts for the broadest measure of trade will be published April 17 in the IMF's World Economic Outlook, according to the officials, who spoke on condition they wouldn't be named because the figures haven't been made public. The IMF, World Bank and Group of 20 finance chiefs gather in Washington April 20-22.

"They can go to Washington looking for kudos," said JPMorgan Asset Management Chief Market Strategist Rebecca Patterson in New York, referring to Chinese officials. "Others will push for more but have to acknowledge this is a step in the right direction."

Market Forces

Christine Lagarde, managing director of the IMF, said she welcomed the widening of the yuan band which "underlines China's commitment to rebalance its economy toward domestic consumption and allow market forces to play a greater role in determining the level of the exchange rate."

Markets reflect optimism China's economy will avoid a deeper slowdown. The yield on 10-year government bonds has risen 10 basis points this year to 3.53 percent. The Shanghai Composite Index has gained 7 percent.

At UBS AG, Hong Kong-based economist Wang Tao said that the widening of the band was a net positive for the economy because greater currency flexibility increases "the independence of monetary policy."

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