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China’s Yuan Plan Tested by Sole Gain Versus Dollar

By Ye Xie and Lilian Karunungan October 31, 2014

The yuan’s best rally since 2011 is testing China’s resolve to take a less controlling approach to its exchange rate.

The yuan is the only major currency to strengthen versus the dollar since mid-year, making exports (CNFREXPY) less competitive at a time when growth is slowing. It’s only been seven months since the People’s Bank of China engineered a record slide in the currency to deter speculators, and analysts say it may need to reprise the strategy if the yuan keeps climbing.

“The central bank appears committed to currency and financial-market reforms,” Eswar Prasad, a former International Monetary Fund economist and now professor of trade policy at Cornell University in Ithaca, New York, said by e-mail on Oct. 28. Present circumstances “are testing that resolve,” he said.

China is performing a balancing act. While it wants a weaker currency for the sake of the economy, its central bank has signaled it wants to move toward a market-determined exchange rate as it seeks to promote the yuan in international trade. The PBOC allows the yuan to fluctuate as much as 2 percent on either side of a daily reference rate.

The Chinese monetary authority’s press office didn’t return phone calls seeking comment yesterday.

Boosting Investment

China’s global ambitions for its currency are encouraging investment from overseas, making it harder for the authorities to curb the yuan’s gains. Its share of the money transferred around the globe rose to a record 1.72 percent in September, making it the world’s seventh most-used currency, the Society for Worldwide International Financial Telecommunications said.

China’s currency strengthened 1.5 percent versus the dollar since June, the only one of 31 major exchange rates to rise versus the greenback. The yuan reached an eight-month high of 6.1083 per dollar today, before trading at 6.1130 at the close in Shanghai. It’s climbed for six straight months, the longest winning streak since August 2011.

“China will likely allow some weakening of the yuan” to relieve pressure on the economy, Hamish Pepper, a strategist at Barclays Plc in Singapore, said by e-mail on Oct. 28. “Cuts in benchmark interest rates as well as targeted easing” are likely, he said.

Barclays sees the yuan falling about 2 percent to 6.23 per dollar by Dec. 31. Median estimates of strategists in a Bloomberg survey predict levels of 6.12 by the end of this year and 5.99 by the end of 2015.

Record Slide

Any determined attempt to stem the yuan's gains would recall the events of the first quarter. To stop investment from causing an asset bubble and speculators from viewing the yuan as a one-way bet, China started lowering in January the reference rate that determines the band in which the yuan floats versus the dollar. By the end of March, the currency had tumbled 2.6 percent, the biggest drop in a quarter since 1994.

China has taken its foot off the brakes since then. Policy makers have reduced currency intervention to "almost zero,"and are getting "closer and closer" toward the goal of a market-set exchange rate, PBOC Deputy Governor Yi Gang said Oct. 11 at the IMF meeting in Washington.

Net purchases of dollars by the PBOC, generated by selling the yuan to weaken it, amounted to about $21 billion in the six months through September, down from $106 billion in the first quarter, Nomura Holdings Inc. estimates.

Trading Accords

China has signed agreements with overseas authorities to allow direct trading between the yuan and the euro, dollar, pound and yen, and appointed yuan clearing banks in Frankfurt, Paris and Luxembourg.

China's attempts to make the yuan a truly global trading currency are a strong incentive not to step in to weaken it. Anyway, says investor TCW Group Inc., a lower exchange rate isn't going to boost the domestic economy, where much of the slump is the result of a real-estate downturn.

"A weaker currency isn't going to help the part of the economy that is hurting," David Loevinger, a former U.S. Treasury Department official who's now a Los Angeles-based analyst at TCW, which manages $144 billion in assets, said by phone on Oct. 28. "Exports look relatively strong," so China"had better stick to the reform path."

Exports from China rose 15.3 percent in September from a year earlier, topping the 12 percent forecast of economists surveyed by Bloomberg. That doesn't tell the whole story because of speculation the figure was boosted by short-term fund flows - - a sign speculators may have already returned to China's currency markets.

Export Competitiveness

The yuan's inflation-adjusted exchange rate against the currencies of China's major trading partners rose 7 percent since May to a record earlier this month, according to Barclays data. That suggests China's currency is becoming uncompetitive for exports. Gross domestic product expanded 7.3 percent in the third quarter from a year earlier, on pace to miss the government's 7.5 percent 2014 target.

That's why the nation's tolerance of a stronger yuan is wearing thin, said Sue Trinh, a senior foreign-exchange strategist at Royal Bank of Canada, which predicts a decline to 6.2 per dollar by the end of 2015.

"If the exchange rate moves in a direction that's inconsistent with the fundamentals, it will be tested," Hong Kong-based Trinh said by e-mail on Oct. 29. "We cannot rule out anything from the PBOC when it comes to managing the yuan."

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