

OCTOBER 4, 2011, 9:00 P.M. ET

China's Yuan Hitches Ride On Surging Dollar

(This article was published earlier Tuesday.)

By Erin McCarthy
Of DOW JONES NEWSWIRES

NEW YORK (Dow Jones)--The dollar's got some unexpected competition for the title of world's hottest currency.

The yuan is one of the few currencies to top the dollar's recent surge against the likes of the euro and Australian dollar. Only the dollar trades freely, with the yuan guided by a trading range set by the People's Bank of China, the country's central bank. But China has raised the yuan's reference rate by about 4% this year, including nine increases in September, when the free-ranging dollar's value was soaring.

It's a move that flips the script for the world's second-biggest economy and its trading partners, who have complained for years that China is keeping the yuan artificially weak to give its exporters an edge. But what counts for a big move in the yuan isn't placating critics in the U.S. Senate, which on Monday voted to move ahead with legislation that would punish China for its currency policy. The bill has yet to be approved by the U.S. House or President Obama.

Until recently, the yuan looked cheaper than ever, thanks to the greenback's much steeper decline against most other widely circulated currencies. That all changed last month, when investors nervous about the escalating European debt crisis and a global economic slowdown started buying dollars. Toss in the People's Bank of China's rate adjustments, and the yuan's "real effective exchange rate," which compares the currency to a basket of its major trade partners and adjusts for inflation, jumped 2.3% in September to its highest point since Beijing loosened its grip on the yuan in June 2010, according to JPMorgan.

But exporters competing with Chinese companies say a month's worth of rapid trade-weighted appreciation isn't enough.

"The fundamental problem is they're still manipulating their currency," said Thomas Gibson, head of the American Iron and Steel Institute, a trade group that supports the Senate bill.

And the U.S. Senate vote was only the latest regulatory action with China in sight. Last month, Brazil increased a tax on cars with a high content of imported parts, a move to help local producers compete against cheap imports from places including China. Brazil, which first coined the phrase "currency war" last year, has pointed fingers at countries-- including China and the U.S.--it says pursue policies resulting in weaker currencies.

The PBOC, in response to the U.S. Senate vote, said the legislation could lead to trade disputes and affect Beijing's ongoing exchange-rate reform. The bank added that the yuan is close to a balanced level. China is not trying to win friends; a stronger yuan would help reduce inflation and increase domestic buying power.

China's leadership "is trying to maintain peace with its trading partners while trying to keep its domestic constituencies happy as well," said Eswar Prasad, a professor of trade policy at Cornell University.

Plenty in the market believe the dollar could backslide and that the yuan's relative strength is only temporary. If the greenback rises further, China could actually depreciate the yuan against the dollar and keep it steady against its trading partners' currencies. Traders have recently pushed the yuan to the lower end of the trading band allowed by China's central bank, a possible signal that the currency could soon depreciate.

However, many analysts and traders believe the most likely scenario is for China to allow the yuan to appreciate gradually, reshaping global trade over a period of years. That rebalancing should move forward so long as the yuan appreciates against the dollar by between 4% and 6% annually, said Adam Wolfe, senior research analyst at Roubini Global Economics.

China's current account surplus, a measure of the country's exports versus imports, was already falling before September, reaching 2.8% of gross domestic product in the first half of 2011, down from 5.0% a year earlier. China's export prices are also rising due to domestic cost increases and yuan appreciation, said Royal Bank of Scotland's chief China economist Li Cui.

"The price adjustment is taking place more through real appreciation. It's a modest first step, nonetheless it's a significant first step," she said.

-By Erin McCarthy, Dow Jones Newswires; 212-416-2712; erin.mccarthy@dowjones.com

-Paulo Winterstein contributed to this article.