The Economist

China’s currency

One way no more

Why China’s central bank is weakening its currency

Mar 1st 2014 | HONG KONG | From the print edition

CHINA’S currency has long been a source of controversy, especially among American politicians outraged by its cheapness. But it is rarely a source of uncertainty. Critics have argued fiercely about what it should be worth. But as to what it would be worth, China’s authorities have left little room for disagreement. For much of its history it has been pegged tightly to the dollar. More recently it has floated within a narrow band (now 1% either side of a benchmark fixed each morning by the central bank). Most people have assumed it would float upwards.

In recent days, however, China’s authorities have tested that assumption. At a two-day meeting ending on February 18th, the central bank decided to weaken the yuan, according to the *Wall Street Journal*. It has lowered its benchmark by a smidgen at a time for several days. The currency has also fallen from the strong side of its band to the weak side. In the space of a few days, it lost about 1% of its value. On February 26th China’s foreign-exchange regulator said that China’s ongoing exchange-rate reforms meant that “two-way fluctuations... will become the norm”.

For the past year, a different norm has applied: the fluctuations have been mostly one way. China enjoys a sizeable current-account surplus and it still attracts more foreign-direct investment than it provides. Other kinds of capital flows are more volatile. But in the last quarter of 2013, a net $22 billion of “hot money” flowed inwards. Much of this qualifies as a “carry trade”: speculators have borrowed cheaply in dollars, then lent in yuan, eluding China’s capital controls in the hope of benefiting both from higher Chinese interest rates and the yuan’s appreciation.

All of this has put upward pressure on the currency, fulfilling the carry-traders’ designs and inspiring others to emulate them. Despite the central bank’s heavy purchases of foreign exchange, the yuan rose by 2.8% against the dollar in the year to January, even as the currencies of other emerging markets plummeted. The resulting loss of competitiveness is best illustrated by an index calculated by the Hong Kong Monetary Authority, which compares China’s currency with those of other emerging economies that compete with it in third markets (the countries China trades “against”, not necessarily the countries it trades “with”). This index shows the yuan rising by over 13% in the year to January and by almost 2.6% in January alone (see chart).

China’s authorities did not say they had stepped in to sap the yuan. But their intervention left fingerprints all over the money markets. In buying dollars to weaken the currency, the monetary authorities (and their accomplices, the state-owned banks) put additional yuan into circulation. The central bank withdrew a fraction of this extra money by selling securities to the banks. But the banks were still left with extra yuan, which they tried to lend to each other. This pushed down interbank interest rates, despite the central bank’s withdrawals. As Yao Wei of Société Générale points out, “No factors other than foreign-exchange intervention seems able to explain that.”

Will the yuan’s slide persist? In its statement, the foreign-exchange regulator pointed out that export earnings and foreign-direct investment remain strong. These fundamentals both suggest the yuan should rise again. But by wrongfooting the speculators, the authorities hope that the expectation of appreciation will not remain a cause of that appreciation.

At the meeting in which it decided to cheapen its currency, the central bank also decided to enlarge the yuan’s trading band later this year, according to a statement cited by the *Journal*. A more flexible yuan would give the central bank a freer hand in setting monetary policy, even as it gradually permits larger cross-border flows of capital. Despite its cruelty to carry traders, the central bank seems to be keen to open the door to foreign capital a little wider, as long as foreigners do not try to barge their way in. That will make China’s currency a source of less controversy but a good deal more uncertainty.

From the print edition: Finance and economics