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China unleashes yuan bears, but can it cage them again?

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By Pete Sweeney and Lu Jianxin

SHANGHAI (Reuters) - Beijing's attack on yuan speculators has proven extraordinarily successful, so much so that traders no longer see it as a short-term intervention but a deeper market shift that has now gained a self-reinforcing momentum.

That's bad news for speculators still holding onto bullish yuan positions. And for the People's Bank of China (PBOC), the risk is it has unleashed bearish forces it may not be able to rein in, souring enthusiasm for the yuan and complicating the push to increase the international adoption of the currency.

"The market had expected the yuan's weakness to last no more than a few weeks, but the PBOC has now sent clear signals that it is the central bank, not the market, that will decide when the yuan's weakness will end," said a trader at a European bank in Shanghai.

"With the PBOC giving no signal that it intends to do so, corporates have become alarmed, and many are now building dollar positions to hedge."

Since the central bank started aggressively pushing the currency lower in February, to shake the market out the view the yuan was a one-way bet, it has fallen more than 3 percent and more than unwound its gains of 2013.

On Wednesday, it touched an 18-month low of 6.2676 per dollar. Markets were closed for holidays on Thursday and Friday.

For its part, the PBOC has continued to set the daily midpoint rate near seven-month lows, which traders say signals it is still happy with current levels.

Initially, traders said the PBOC had to play hard ball to convince them it was serious -- especially since its last attempt to pull back the yuan in late 2012 was widely considered a failure.

Instead of relying solely on using the midpoint to guide the market, traders said the PBOC also ordered major state-owned banks to buy dollars and dump yuan. Facing that much firepower, smaller market players had no choice but to follow.

But now dealers say such intervention is no longer necessary; "animal spirits" have taken hold and, in the context of wider economic malaise, given the trend a momentum of its own.

And following the doubling of the yuan's trading band in March to 2 percent either side of the midpoint, the market has a much bigger say over the direction of intra-day trade.

LESSONS FROM 2012

For investors clinging to bullish derivative bets, and for foreigners who moved funds into Chinese equities and bonds in recent months, signs that market sentiment is souring on the yuan are unwelcome.

"Short-term flows do tend to exhibit herd behavior, which could generate unstable capital-flow dynamics in the short run," said Enswar Prasad, economist at Cornell University and former head of the International Monetary Fund's China division.

"Further depreciation of the renminbi (yuan) could feed on itself as domestic capital could start leaving China in search of higher returns and for diversification purposes."

The last episode of sustained yuan weakness was more moderate, with the currency losing about 1.6 percent over five months in the first half of 2012.

Even that had a noticeable negative impact on offshore sentiment toward the yuan, a setback for Beijing's project to make its currency a rival to the dollar.

Perhaps with that in mind, the PBOC has moved to further ease cross-border flows for major multinationals, another step in opening up its capital account.

In addition, the Ministry of Finance has moved to support the offshore yuan market in Hong Kong by announcing it will issue a record 28 billion yuan of offshore dim sum bonds this year.

WEAK YUAN, BIG LOSSES

Morgan Stanley said in March it expected speculators could incur losses of up to $200 million per month if the yuan fell below 6.20 yuan per dollar. It weakened past there on March 19 and has been there, for the most part, ever since.

Prasad does not believe Beijing is running a major risk by leaving the market down for a little while longer, and said the easing of rules on cross-border flows was a sign of confidence that panic outflows would not ensue.

And Goldman Sachs Global Macro Research said in a report published on April 25 that long-term fundamental inflows have so far been largely unfazed by the yuan's decline.

But with the economy growing at its slowest annual pace in 18 months in the first quarter and economists saying it could slow further, there is little to suggest a turnaround in yuan sentiment.

"With credit efficiency declining and funding costs up, the re-acceleration in credit required to revive growth will likely need to be even larger this year," BNP Paribas chief Asia economist Richard Iley said in a research note.

"More yuan weakness is, of course, the other option."

(Editing by John Mair)

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