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China Shifts Course, Lets Yuan Drop

By BOB DAVIS And LINGLING WEI

The People's Bank of China guided the Chinese currency to its weakest level of the year. The WSJ's Hong Kong Bureau Chief Ken Brown tells Mariko Sanchanta why China is changing its course.

BEIJING—China's central bank is starting to guide the yuan downward against the dollar after two years of trying to boost its value, reflecting concern in Beijing over China's slowing economy—and risking a political fight with the U.S.

The People's Bank of China guided the Chinese currency to its weakest level of the year on Wednesday against the U.S. dollar, the third straight day of a push to bring down the yuan's value. Overall, the yuan has fallen 1.1% against the dollar this year after rising 4.7% against the U.S. currency last year.

The PBOC didn't respond to requests for comment, and it isn't clear whether the trend will continue in coming days and weeks. A similar steering of the yuan to weaken was seen in early May, which was then followed by a return to the usual practice of seeking to let it remain stable or to strengthen against the dollar. On Thursday morning in China, the PBOC appeared to try to limit the yuan's recent fall.

Traders and analysts say the shift in the last few days is aimed at helping exporters cope with slowing sales and reducing the chances of major layoffs ahead of a major—and sensitive—once-a-decade Chinese leadership change set to begin later this year. A

cheaper yuan makes Chinese goods less expensive in dollar terms.

Premier Wen Jiabao last week warned that "the task of promoting full employment will be very heavy and we must make greater efforts to achieve it."

The psychological impact of a weakened yuan "will be strong," said Dariusz Kowalczyk, a Crédit Agricole senior economist based in Hong Kong. "It creates an impression that Beijing is so focused on minimizing risks to growth that it is ignoring any U.S. pressure."

The U.S. Treasury declined to comment. But a fall in the yuan is bound to keep it a political issue in the U.S. during an election year. Treasury Undersecretary Lael Brainard said last week that China should "avoid persistent exchange-rate misalignment," although she credited China with making some progress on the currency front. Republican presidential challenger Mitt Romney has said he would name China a "currency violator," a designation that could trigger a confrontation with China.

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Meanwhile, on Wednesday the International Monetary Fund reiterated its contention that China's currency is "moderately undervalued" against a basket of currencies. The IMF didn't specify the degree of undervaluation in its annual assessment of China's economy, but individuals who track the IMF say the yuan is likely to be judged to be undervalued by less than 10%.

China's representative to the IMF, Zhang Tao, said the IMF's characterization "is not consistent with the reality." He said the currency is "roughly in equilibrium," meaning it didn't have to rise much more, if at all.

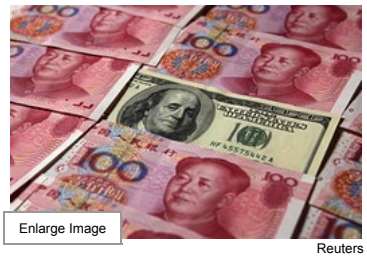
Beijing has its eyes trained on not just the dollar. The European Union is China's No. 2 export market after the U.S., and the yuan has appreciated 5.6% against the euro since January. During that time, the dollar has risen 6.9% against the euro. By reducing the value of the yuan against the dollar, the PBOC slows its rise against the euro.

That provides some help to Chinese exporters who are feeling the effects of Europe's continuing debt crisis. "We've seen a sharp drop in demand from Europe," said Xu Peng, an official at Huihong International Group, a state-owned textiles company, which has started to take out trade insurance to guard against potential nonpayment from European clients.

The PBOC sets a daily rate, called the parity rate, for the yuan's trade against the dollar in the mainland currency market. The central bank then lets the yuan rise or fall by 1% in daily trading. Monday, the PBOC set the parity rate weaker against the dollar than Friday, according to data provider ChinaScope Financial in Hong Kong. It continued that pattern the next two days. On Thursday morning, the PBOC set the daily rate stronger against the dollar than the previous day.

With $3.24 trillion in foreign-exchange reserves, the Chinese government has the wherewithal to assure the continuing steady rise of the yuan. But such a move could be interpreted as a signal money is fleeing China.

"Authorities certainly don't want to signal any weakness," said Brookings Institution China scholar Eswar Prasad. "So they will intervene very cautiously."



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