THE WALL STREET JOURNAL.

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FOREIGN EXCHANGE

China Warms to a More Flexible Yuan

Beijing Has Ambitions to Raise Yuan's Global Status In Effort to Challenge U.S. Dominanc

China is growing more willing to let the yuan depreciate modestly while seeking to add flexibility to its trading, say Chinese officials and experts. *REUTERS*

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Dec. 17, 2014 5:26 a.m. ET

After years of allowing nearly uninterrupted gains in the yuan, China is growing more willing to let it depreciate modestly while seeking to add flexibility to its trading, according to Chinese officials and experts familiar with the country's policy-making.

The shift comes as the People's Bank of China grapples with what some within the central bank call "unprecedented" downward pressure on the yuan, thanks to a strengthening U.S. dollar and a slowing Chinese economy. The yuan has fallen more than 2% against the dollar since the beginning of this year, putting it on track for its first annual decline in five years. On Wednesday, it was down 2.3% against the dollar for the year.

But the PBOC is unlikely to permit the yuan to slide more than 3% against the dollar, the officials and advisers to the central bank say. Big yuan depreciation could cause money to flow out of the country just when China needs funds to spur economic growth.

Beijing also is gunning for the International Monetary Fund to declare the yuan—also known as the *renminbi*, or the people's currency—a global reserve currency next year, like the dollar, the euro and the Japanese yen, the officials say. A key criterion is whether a currency is widely used in global trade and finance; Beijing believes a falling yuan would be less appealing to businesses and investors.

Late next year, the IMF will review the list of currencies countries can include in their official foreign-exchange reserves.

"There will be bouts of depreciation in renminbi next year, especially in response to any further easing of the monetary policy," says a Chinese official close to the central bank. "

But overall, the exchange rate should remain relatively stable," the official says. "Greater trading flexibility is entirely possible."

China's leadership has been trying to raise the yuan's global status as a way to challenge the U.S.'s dominance in world affairs. Though increasingly important in international trade, the yuan isn't freely convertible. The PBOC sets the value each day, permitting the yuan to fluctuate within a limited range against the dollar.

Since 2012, the central bank has twice expanded that band. Making the currency more market-driven fits with Beijing's broader effort to transform the economy so that it relies more on domestic consumption, rather than investments, for growth. By making it easier to convert cash into other currencies, a freer yuan could give consumers more flexibility in terms of spending and investments.

Despite those moves, China's management of the yuan has remained a source of friction in Washington, with lawmakers in both parties pressing the Obama administration to push China harder to loosen its grip. Many in Congress have accused China of currency manipulation and said that by keeping the yuan weak, China has restrained U.S. exports and cost American jobs.

Now, a surging U.S. dollar presents China with a challenge. In addition to potentially adding to pressure from Congress, a weaker yuan could cause people to take money out of China, despite Beijing's tight controls on capital, just as fewer funds are flowing in.

The latest official data show that the PBOC and China's commercial banks bought only 2.7 billion yuan of foreign exchange last month, down sharply from 66.1 billion yuan in October. The purchase totals are often seen as a proxy for the amount of foreign currency entering China.

On the other hand, if China moves to make the yuan appreciate against the dollar, that could hurt exporters, making goods made in China more expensive in the U.S. and other foreign markets. Beijing argues that the current slowdown in its economy indicates the yuan is nearing the level where it should reach equilibrium with the dollar.

"The exchange-rate policy will be one of the most complicated macro policies in China in 2015," says Haibin Zhu, China economist at J.P. Morgan Chase & Co.

Economic weakness that led the PBOC to cut interest rates last month, coupled with expectations that U.S. short-term rates will rise next year, have made it less appealing to hold yuan assets. Many investors who have bet the yuan would rise, borrowing dollars at low interest rates to buy the currency, have been unwinding those transactions in recent weeks, reasoning that China is likely to take more steps to bolster its economy.

More interest-rate cuts would reduce the returns available from yuan assets, making gains in the currency less likely.

The PBOC has tried to guide the yuan upward in recent days, but the currency has fallen. On Wednesday, the yuan ended the day at 6.1975 per dollar.

Tao Wang, China economist at UBS AG, said she expects a "modest depreciation" of the yuan next year. The currency is likely to weaken to 6.35 per dollar by the end of 2015, she predicted.

Roland Gabert, a senior portfolio manager at Deutsche Asset & Wealth Management in Frankfurt, which manages $1.3 trillion, said he reduced his bullish bets on the yuan last month because he was concerned that the dollar's rise would weaken Asian currencies across the board.

"The dollar's movement has been quite impressive, so that could be a risk for China," Mr. Gabert said.

Some investors have chosen to bet against the yuan. One of them is Mark Bower, head of emerging markets at Bienville Capital Management, a $750 million investment firm. Mr. Bower dismissed China's still-growing trade surplus, normally a factor that would cause a currency to rise, saying that has more to do with shrinking domestic demand and weak commodities prices globally than with a rise in Chinese exports.

"The fact that over the last six months the yuan hasn't really moved much is making China's competitiveness worse and worse at a time when the domestic economy is slowing," Mr. Bower said.

Currently, the PBOC allows investors to push the yuan's value 2% in either direction from its reference rate in daily trading. Many people inside and outside the PBOC expect the range to be further widened next year. The last time the band was widened was in March, when it was increased to 2% from 1%.

"The strength of the dollar and the weakening domestic economy give China a window of opportunity to further increase the yuan's flexibility without fueling a wave of speculative capital inflows in anticipation of yuan appreciation," says Eswar Prasad, a China expert at Cornell University and the former head of the IMF's China operation.

The PBOC is likely to widen the yuan's band "when it views the pressures on the currency as roughly balanced in either direction," Mr. Prasad adds.

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