ASIA MARKETS

Yuan's Decline Raises Concerns Over Currency War

U.S. Officials, Others Believe China Is Intentionally Keeping Currency Below Market Value

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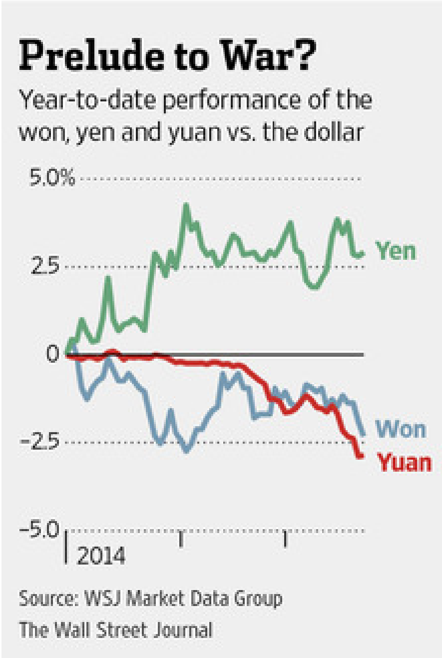
A clerk counts 100 Chinese yuan banknotes at a branch of China Merchants Bank in Hefei, Anhui province, on March 17. *Reuters*

BEIJING—The recent sharp decline in the Chinese currency is threatening to exacerbate China's trade tensions with the U.S. and raising concerns over a potential currency war in Asia.

China's central bank has intervened since late February to drive down the value of the yuan against the U.S. dollar by 2.8% so far in 2014, almost erasing all of its gains last year and ushering in a rare period of weakness for a currency which has steadily appreciated over the past decade.

The People's Bank of China argues the depreciation is needed to drive out speculators who were betting the yuan would continue to rise, according to people with direct knowledge of the central bank's thinking.



Bank officials also contend China's move to allow market forces to p yuan's value has exacerbated the weakness, according to these people.

On March 17, the central bank doubled the range in which the yuan is permitted to trade—part of efforts to liberalize the financial system. Market participants, worried over recent signs of slowing economic growth, have taken this as a cue to sell yuan, Chinese officials say.

Beijing argues the yuan is approaching its fair-market value, pointing to the country's shrinking trade surpluses. On Saturday, Yi Gang, a PBOC vice governor, told an economic forum in Beijing that in the future the yuan's exchange rate "will be more and more determined by the market" and the PBOC's "decisive role in the exchange rate will weaken."

Still, officials and politicians in the U.S. and other Asian nations believe China is intentionally keeping the yuan below its true market value to give exporters an edge over competitors in overseas markets.

U.S. Treasury Secretary Jacob Lew welcomed China's widening of the yuan's trading band, saying it is a step toward greater exchange rate flexibility. But Mr. Lew last week told Chinese Vice Premier Wang Yang in a phone conversation the U.S. believes Beijing has further to go before the exchange rate is market-determined, according to a Treasury statement.

The U.S. Treasury Department, in an October report to Congress, criticized China's intervention in currency markets and argued the yuan would need a "substantial" appreciation to be near market-determined rates. Since then, the yuan has fallen over 2%.

A persistent drop in the yuan also risks igniting a race among Asian countries to devalue their currencies. Japan's economic recovery last year was spurred by monetary easing and a dramatic fall in the yen's value, raising tensions with export rivals like South Korea.

China, too, saw its currency rise strongly against a number of countries last year as foreign capital retrenched from other emerging markets. The yuan, which is protected by strict capital controls, remained steady against the dollar, while currencies like the Indonesian rupiah and Indian rupee plunged. Now, the yen is strengthening again, while the Korean won and yuan fall.

"A fresh spate of currency tensions could ensue if the PBOC is seen as intervening heavily to keep the value of the yuan down," says Eswar Prasad, a China expert at Cornell University and a former senior China official at the International Monetary Fund.

"With capital beginning to flow back to some emerging markets, a weaker yuan could increase pressures on other central banks, especially those in Asia, to prevent their own currencies from appreciating."

To be sure, China's trade surplus has narrowed sharply in the past few years, as policy makers tilt the economy to rely more on consumption and less on exports. And many expect the yuan, also known as the renminbi, to continue its upward climb later this year, fueled by capital inflows.

Some observers, though, say the decline shows China still views export competitiveness as important. The yuan stabilized Friday after falling four consecutive trading sessions following the band widening.

Analysts at Capital Economics, a London-based research firm, estimate the PBOC purchased some $25 billion last month to weaken the yuan. China so far hasn't used its $3.8 trillion in foreign reserves to prop up the yuan.

"I'm surprised that the Chinese would let the renminbi drop so far so fast so long," said C. Fred Bergsten, a senior fellow at the Peterson Institute for International Economics, a Washington-based think tank. "If the movement continues much further, it will clearly reignite the currency manipulation charges in the Congress and elsewhere here," he said.

Sherrod Brown, a U.S. Democratic senator and a member of the Senate Finance Committee, on Thursday called on Congress to pass a law to sanction China.

"As the Chinese government continues to push down the value of the yuan, the urgency for passing our bipartisan bill addressing currency manipulation rises," Mr. Brown said.

China's economy weakened sharply during the first two months of this year, deepening concerns that current growth of around 7.5% may decelerate further. China's top leaders now face tough decisions about whether to set aside economic overhaul measures—such as reining in runaway credit—that could pinch growth in the short term.

The central bank is waiting for more data to determine whether it needs to loosen monetary policy, according to a person with direct knowledge of the PBOC's thinking.

Signs China is using its currency to deal with economic problems would intensify tensions, said Mr. Bergsten of the Peterson Institute. "They are clearly flirting with serious new troubles," he said.

—Ian Talley contributed to this article.

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