China’s currency

Squeezed to life

The yuan defies predictions ofgloom

with a strong startto the year

T

HE omens for the Chinese yuan

seemed bad headinginto 2017. The cap-

ital accountlooked asporousasever, mak-

ing a mockery of the government’s at-

temptsto fixthe leaks. The newyear, when

residents received fresh allowances for

buying foreign currency, was due to bring

even more pressure. Analysts braced for a

stampede for the exits from China. The

yuan had fallen sharply at the beginning

of 2016, catching them by surprise. This

time, theywere ready.

Instead, the yuan began the yearas one

of the world’s star performers. This was

particularly so in the offshore market,

where foreigners trade it most freely. It

gained 2.5% against the dollar over two

days in the first week of 2017, its biggest

two-dayincrease since 2010, when trading

began in HongKong, itsmain offshore hub.

Within China itself, price increases were

more subdued, but the yuan still climbed

to a one-month high.

Currency markets are notoriously fick-

le, so itisdangerousto read too much into a

few days ofprice swings. But in China the

governmenthasalwayshad a tightgrip on

the yuan. So the currency’sstrength raised

the question of whether it was simply be-

ing propped up—or whether the yuan’s

prospectswere in factimproving.

The Hong Kong rally has the Chinese

central bank’s fingerprints all over it. The

proximate cause wasa shortage ofyuan in

Hong Kong. As its residents have turned

away from the Chinese currency, deposits

there have fallen to just over 600bn yuan

($86.7bn), their lowest level since early

2013. That has led to periodic liquidity

squeezes, making the cost of borrowing

yuan in Hong Kong prohibitive: the over-

nightrate soared to 61% atthe startof2017.

In normal circumstances, central banks

would be expected to injectmoneyto ease

such shortages. But the Chinese authori-

ties did little to stem the cash crunch,

pleased to see it hurt those betting against

the yuan. To make money by “shorting” a

currency, investors borrow it, sell it and

then hope to buy it backafterits value has

fallen. With borrowing rates so high, this

becomesall butuntenable. Asthe liquidity

squeeze has abated in recent days, the off-

shore yuan haspared itsearliergains.

China’s success in defending the yuan

suggests that, as the government tightens

capital controls, they are having more ef-

fect. In the past two months it has started

reviewing all transfers abroad by compa-

niesworth $5m ormore. Transfersbyindi-

viduals will also soon face more scrutiny.

The controls should slow the erosion of

China’s foreign-exchange reserves, which

are down to $3trn from $4trn in 2014.

Most important, the Chinese economy

issounderthan itwastwo yearsago, when

the yuan’s gradual descent began. A prop-

erty boom has breathed life into heavy in-

dustry. Producer-price inflation is running

atitsfastestin more than halfa decade. The

central bankistighteningmonetarycondi-

tions, however gingerly. As China’s eco-

nomicand policycyclesmore closelytrack

those in America, there is less scope for

runaway strength in the dollar, which in

turn takespressure offthe yuan.

Even so, manyofthe factorsremain that

led the yuan to drop by 7% last year, its

steepest fall on record. The broad money

supply is still growing at a double-digit

rate. Chinese companies and households

still have a ravenousappetite forforeign as-

sets. Mostanalystsexpectthe yuan soon to

startfallingagain, though thatconsensus is

no longer rock-solid. China’s central bank

has long said that it wants to make the

yuan more volatile and less predictable.

On thatscore, ithassurelysucceeded.