

China Rethinks  
The Peg Tying  
Yuan and Dollar  
Outside Pressure to Delink,  
Beijing's Fears of Losing  
Control Prod Possible Shift

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BEIJING -- Pressures building within China's hard-charging economy are driving Beijing to re-examine the Chinese currency's iron-like tether to the U.S. dollar, with a loosening looking more and more like a matter of when, not if.

The U.S., the European Union and other trading partners have urged China to let the yuan float, contending that the currency is undervalued and fueling a predatory export boom. But it is internal economic concerns -- not outside political pressures -- that are occupying Chinese leaders' minds. The financial system is awash with money. The amount of cash and private deposits surged 20% last year, twice the rate of the torrid economy. With so much money around, banks are lending at a similarly brisk pace. Inflation, dormant for most of last year, has picked up, and in December it rose 6% over the previous month.

"The monetary authorities are losing control of the economy," says Hong Liang, China economist for Goldman Sachs & Co. in Hong Kong.

The communist leadership, which prizes control above almost everything else, is signaling that the current situation may be untenable and that it is weighing its options. Premier Wen Jiabao told a high-level meeting of economic officials in Beijing this week that the government will "maintain the basic stability of the yuan," with an emphasis on the qualifier "basic." Mr. Wen also said the government intended "to gradually perfect" the exchange-rate mechanism.

A change in the yuan's value would be the biggest shift in monetary policy in a decade. In the most recent major change, China abolished a two-track system -- with different exchange rates for foreigners

with hard currency and Chinese -- while placing the yuan in a narrow trading band, or desirable range of values in relation to the dollar. Mr. Wen's comments are particularly significant because, unlike the independent central banks in most developed economies, the People's Bank of China serves more as an authoritative policy body. The political leadership oversees major decisions.

## Options Narrowed

In grappling with the unintended effects of rapid economic growth, China's central bank is seeing its options narrowed by the current dollar peg of the yuan, Chinese officials and economists say. To maintain the peg and keep the yuan falling in tandem with the declining dollar, the People's Bank of China mounts costly money-market interventions, buying dollars from commercial banks, replacing them with yuan and then issuing to the banks short-term bills to sop up the money in circulation.

