

## IMF Urges China to Pursue Greater Exchange Rate Flexibility

*Following are excerpts of David Burton's address at the 2004 Credit Suisse–First Boston Asian Investment Conference in Hong Kong SAR on March 23.*

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“There is a view that the inflexibility of exchange rates in the region—especially in China—reflects a deliberate development strategy centered on export-led growth and an undervalued exchange rate. Some observers have also argued that the accumulation in reserves may be sustainable for some time, especially as the large supply of low-wage labor in China will keep inflationary pressures in check. It is certainly true that reluctance to see exchange rates strengthen against the dollar stems in part from concerns about the implications for growth and job creation. At the same time, it should be remembered that China stuck to its peg to the dollar throughout the Asia crisis while other countries in the region were depreciating sharply. Also, China maintained subsequently the present peg as the dollar strengthened through 2001. So China's exchange rate policy, in my view, at least partly represents a desire for stability and continuity. That said, I do not buy the argument that China's reserve accumulation can be sustained indefinitely without inflationary consequences. Even though the pool of low-wage labor is large, pressure will be put on the prices of other scarce factors, including land and skilled labor. And we can already see signs that inflation in China is picking up. In the end, real exchange rates will adjust one way or another.

Concerns have been raised by some observers that it would be premature for China to move toward exchange rate flexibility before resolving the weaknesses in its financial system. But this argument presupposes that greater flexibility would be accompanied by capital account liberalization that could trigger outflows from banks. In fact, there is no reason why limited exchange rate flexibility should pose significant risks for the financial system if capital controls stay in place. And experience in many other countries, with India a relevant recent example, shows clearly that managed exchange rate flexibility can be successfully introduced before capital account liberalization has gone very far.

What is the best way for China to proceed? Unfortunately, there is no ideal first move toward flexibility. Options include widening the band against the dollar or pegging the renminbi to a basket of currencies, or some combination of the two. A step-adjustment could also be made as part of an initial move. Any approach, however, could involve costs. In particular, inflows could be exacerbated in the short term if the move was seen as a prelude to further appreciation. This risk could be ameliorated by some very cautious further loosening of controls on capital outflows. There are, though, no easy or risk-free solutions to this complex issue, and it is for the Chinese authorities to decide how best to move toward their stated medium-run goal of exchange rate flexibility.”

The full text of David Burton's speech is available at [www.imf.org/external/np/speeches/2004/032304.htm](http://www.imf.org/external/np/speeches/2004/032304.htm)