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- [Lex](#)
- [Comment & analysis](#)
- [Editorial comment](#)
- [Columnists](#)
- [Discussion & polls](#)
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- [Analysis](#)
- [Comment](#)
- [Features](#)
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**Comment & analysis**[Print article](#) | [Email](#)**China should not rush to float its currency**

By Sebastian Edwards

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China is under increasing pressure to abandon its currency peg to the US dollar and to float the renminbi. Editorialists, analysts and investment bankers have pointed out that China's rapid accumulation of international reserves reflects a growing external imbalance. The weak renminbi, it is argued, is putting the global economic recovery at risk. If America's third largest trade partner does not revalue its currency, other regions - in particular the eurozone - will have to shoulder a disproportionate share of world currencies' realignment. A further strengthening of the euro, however, would derail any hopes of prompt European and global recoveries.

Alan Greenspan, chairman of the US Federal Reserve, last month added his voice to those suggesting that China should float its currency. He said China could not continue to peg its currency without endangering its domestic economy.

This is not sound advice. The abandonment of the dollar peg would open a Pandora's box in China and could leave the world economy worse off. Although floating exchange rates are appropriate for middle- and high-income countries, they tend to be highly volatile and destabilising in countries with underdeveloped domestic financial markets and, especially, in those with weak banking sectors. China shares both of these characteristics. Moreover, in the absence of hedging instruments local companies would be exposed to exchange rate risk and the already financially troubled state-owned enterprise sector might collapse. Under these circumstances it is unlikely that the renminbi would become a truly floating currency. A more probable outcome is that the Chinese authorities would rapidly succumb to a "fear of floating" and would intervene in the foreign exchange market in an unpredictable and capricious way.

Some analysts recognise the perils of adopting a floating exchange rate regime in China. Their solution is for China to implement a one-off nominal revaluation. The renminbi would then be re-pegged to a basket of currencies. Although this would avoid the dangers of a floating system, it is not the best option for China or, for that matter, the rest of the world. Instead of abandoning an exchange rate system that has worked well, China should tackle its external imbalance by accelerating the opening of its huge domestic market to international competition.

Most recent analyses have failed to make the crucial distinction between the real and nominal exchange rates. There is little doubt that during the past few years the gap between China's real exchange rate and its long-run equilibrium level (consistent with maintaining external balance) has increased. But revaluing the nominal exchange rate is only one - and not even the best - way of correcting this large real exchange rate imbalance.

It would be more efficient to implement policies that would change the equilibrium real exchange rate itself. Opening up the economy to trade would generate a welcome surge in Chinese imports from the rest of the world. As imports increase the trade surplus would be reduced, and the upward pressure on the currency would subside. Furthermore, once it became clear that China would not succumb to the demands that it float the renminbi, hot money inflows would slow down and the accumulation of

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international reserves would decline.

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After its accession to the World Trade Organisation in 2001, China has taken steps towards opening up its domestic market. However, it remains a relatively closed economy. According to the latest report by the office of the US trade representative, China's international trade regulations lack transparency and the central government continues to use "opaque" practices to "protect non-competitive and emerging sectors of the economy from foreign competition". As a condition for joining the WTO, China committed itself to a schedule of trade liberalisation, including the reduction of tariffs on cars and agricultural products. These tariff reductions are both modest and gradual and there is much room for China to proceed at a faster pace. But import tariffs are not the only - or even the most important - restrictions on international trade. The USTR documents many instances where non-tariff barriers, including arbitrary valuation of imports by customs and "technical standards", have recently been used to control import volumes.

A dismantling of non-tariff barriers and a more rapid and profound reduction of import tariffs would accomplish several objectives. First, it would raise the standard of living of those Chinese consumers who would have access to imported products at lower prices. Second, a higher volume of imports into China would take away much upward pressure on the renminbi and provide a true and lasting contribution to solving current global trade imbalances. Indeed, even a modest acceleration in the opening up process would go a long way towards solving the problem.

The opening up of China's markets to international competition should be accompanied by deep reforms. Banks should be recapitalised, bad loans provisioned fully and state-owned companies' runaway indebtedness curbed. Only when real progress in these areas is made should China begin to consider a reform to its exchange rate regime. Doing it any earlier would be highly counterproductive.

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