Yuan Again on Table for G-7 Dinner

By Owen Brown Dow Jones Newswires
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BEIJING -- The yuan exchange rate is likely to be discussed again when China's finance officials sit down to dinner next month in London with their counterparts from the Group of Seven leading industrial nations.

Zhu Guangyao, director at the international department of China's Finance Ministry, told a business forum that his boss, Finance Minister Jin Renqing, will discuss the yuan during that visit. The Feb. 4-5 meeting of the G-7 -- comprising Canada, France, Germany, Italy, Japan, the U.K. and the U.S. -- comes just four months after the last dinner invitation extended to China. Over a two-hour meal at the G-7's October meeting in Washington, China's top finance officials promised to push forward on financial overhaul in order to adopt a more flexible exchange rate but gave no hint of when that might happen.

As its delegation prepares to depart, China has more food for thought with a discussion paper prepared by the International Monetary Fund staff. The paper argues in favor of greater exchange-rate flexibility and challenges China's strategy of working toward full liberalization of the country's capital account as a precursor to introducing more flexibility into the exchange rate. The IMF paper says China should move toward a more flexible exchange rate as a prerequisite to freeing up its remaining capital controls.

Analysts have been predicting that China will introduce more flexibility into the exchange-rate system it adopted in 1994, as the dollar's slide has put pressure on Beijing to consider the yuan's de facto peg to the U.S. currency. But while markets wait for a widening of the narrow band in which the yuan trades on the current account, China has been chipping away at its capital controls.

Summits such as next month's G-7 meeting and the spring gatherings of the IMF and World Bank tend to prompt speculation that China will bow to pressure and widen the yuan's trading band. Yet analysts are cautious on the outlook for change, based on similar meetings from which China walked away without offering any concessions.

Michael Kurtz, non-Japan Asia strategist for Bear Stearns, anticipates similar disappointment this time around. Mr. Kurtz said Bear Sterns expects the G-7 to maintain its 2004 stance, advocating orderly foreign-exchange markets and flexible currency policies.

"Its intention, and Europe's increasingly urgent desire, is to put upward pressure on Asian currencies, particularly the yuan, rather than upward pressure on the euro or downward pressure on the dollar as in 2004," he said in a note to clients. "Given the likely continuity of the G-7 stance, however, we don't expect much new market or policy reaction from China, or, more broadly, from Asia."

With China's heady economic growth partly blamed on a flood of money from offshore and a stronger-than-expected export performance, some analysts continue to predict that China eventually will widen the yuan's trading band. Those predictions are coupled with the expectation that the yuan would immediately strengthen to the top end of the wider band.

Just to avoid having to keep up with the constant inflow of cash, which topped $200 billion last year, China's central bank is expected to eventually embrace a stronger yuan.

In the 21-page IMF paper, the authors -- **Eswar Prasad**, Thomas Rumbaugh and Qing Wang of the IMF's Asia and Pacific department -- dismiss arguments against flexibility and say a more flexible exchange rate is in China's interest.

They also argue that liberalizing the capital account should be a lesser priority in the short term, as China uses a more flexible exchange rate to adapt to external and internal pressures on its economy.

"Greater exchange-rate flexibility . . . along with a more stable and robust financial system, should be regarded as a prerequisite for undertaking a substantial liberalization of the capital account," they say in the discussion paper titled "Putting the Cart Before the Horse?"

They dismiss fears that greater flexibility might endanger China's weak banking system, saying that existing capital controls, even if somewhat porous, should avoid putting local banks under stress.

The authors also say the competitiveness of China's agricultural sector has improved significantly in recent years, making it less sensitive to external shocks. Some critics have said exchange-rate flexibility might endanger China's agricultural sector, due to an expected fall in the price of farm produce caused by competition from cheaper imports.