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China Wants to Internationalize Its Currency, So It's Easing Capital Restrictions

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Zhou Xiaochuan, governor of the People's Bank of China.
Photographer: Tomohiro Ohsumi/Bloomberg

You can't buy a beer with it. You can't trade in it. Yet China's push to win an arcane currency status bestowed by the International Monetary Fund is driving policy makers in Beijing to ease capital restrictions.

Board members of the IMF will vote this year on whether to add the yuan to its Special Drawing Rights basket along with the U.S. dollar, euro, yen and British pound. An IMF mission in China Tuesday said it will work closely with authorities toward inclusion, which is "not a matter of if but when."

The SDR, an accounting unit usually deployed in bailout packages, would deliver few direct benefits to China's 1.3 billion people. But on Beijing's streets and in the popular press, the issue is being followed, with taxi driver Wang Jiansheng saying the yuan's fate is "definitely important" to China's future and his own.

"Internationalization of the renminbi means that foreign tourists in Beijing could use it in a more convenient way," he said, using the yuan's alternative name. "It's good for us."

People's Bank of China Governor Zhou Xiaochuan and Premier Li Keqiang seem to agree with that assessment. In March, Zhou dropped a plan to speak about monetary policy at a forum in Beijing so he could lobby fellow panelist, IMF Managing Director Christine Lagarde, for admission. A day later, Li promised to speed up financial market reforms to help win access to the SDR, which endows reserve status on a currency.

"It's importance is as a tool to build political support for China's financial and capital account liberalization," said David Loevinger, former U.S. Treasury Department senior coordinator for China affairs and now an analyst at TCW Group Inc. in Los Angeles. "SDR inclusion will lock in reforms."

'Freely Usable'

To admit the yuan to the SDR basket, the IMF has to deem it "freely usable." The currency is convertible for transactions such as trade and tourism while the capital account, which measures inflows and outflows of capital, remains restricted.

"Chinese authorities have stated publicly their interest in including the Renminbi in the SDR basket," the IMF officials said in a statement at the end of their so-called Article IV mission to assess the economy. "We welcome and share this objective and will work closely with the Chinese authorities in this regard."

The IMF also dropped its long-held view that the yuan is undervalued. The People's Daily newspaper had an editorial on May 21 saying SDR inclusion would be "major progress" for yuan internationalization. The IMF's commentary on the yuan Tuesday was reported on popular Chinese website Sina.com.

Controls Relaxed

Currency controls have been relaxed and are likely to ease further this year after Zhou said in March that steps will be taken to increase the yuan's convertibility under the capital account. Steps to free the use of the yuan have already included allowing foreign investors to trade Shanghai-listed stocks through a link with Hong Kong's exchange and giving overseas funds greater access to Chinese stocks and bonds.

The latest initiative was announced on Friday, when Chinese regulators and their Hong Kong counterparts said that cross-border sales of funds can begin July 1 with an initial quota of 300 billion yuan ($48 billion) in each direction. That comes six months after a link between the Shanghai and Hong Kong stock exchanges was opened.

China is pressing ahead with its bid to join the SDR even as its economy slows. Raising the stakes: Capital outflows are tightening domestic liquidity and policy makers are seeking to deleverage the economy after a debt binge.

China must think carefully about costs and benefits and should not subject its financial liberalization agenda "to the desire of putting the RMB into the SDR basket," said former central bank adviser Yu Yongding.

'Financial Fragility'

"Especially due to China's financial fragility, it is still too early to liberalize its capital account," Yu said.

“If a fully liberalized capital account is a condition for joining the SDR, China should and can wait another five years.”

Former Federal Reserve Chairman Ben S. Bernanke Monday warned in a speech in Shanghai that opening the capital account is “a two-edge sword and a drop in the currency could cause panic and an exodus of money, he said. ‘‘When opening the capital account you need to make sure the economy is strong enough to handle the fund flows out,’’ he said.

Zhou and Li have made it clear they think the rewards outweigh the risks and are pressing ahead. The IMF’s Lagarde said in March the yuan ‘‘clearly belongs’’ in the SDR basket.

Zhou Vindicated

Winning admission would be a vindication for Zhou, who for more than five years has pushed for the yuan to be added to the SDR basket, a move that would aid China’s attempts to diminish the dollar’s dominance in global trade and finance. The nation’s ascent to become the world’s second-largest economy has bolstered his case.

‘‘If the international monetary system is more multipolar it will also be more stable,” said Jukka Pihlman, head of central banks and sovereign wealth funds for Standard Chartered Bank in Singapore. “It’s hard to underestimate the importance of this for the entire international monetary system.”

Inclusion could spur as much as 6.2 trillion yuan of net purchases of China’s onshore bonds by end-2020, Standard Chartered estimates. AXA Investment Managers says about 10 percent of the $11.6 trillion of global reserves will flow into yuan assets. It didn’t give a timeframe.

Standard Chartered, which says the yuan broadly meets SDR criteria, estimates a 60 percent chance of it gaining admission this year; Deutsche Bank puts it at a 40 percent chance this year and 60 percent in 2016.

Rebuff Risk

A rebuff for China may have consequences for the global financial architecture if it encourages a go-it-alone approach. China already has backed new institutions including the $100 billion Asian Infrastructure Investment Bank, a $50 billion development bank in conjunction with fellow BRICS nations, and a $40 billion fund to revive the ancient Silk Road trade route.

They are being set up after years of frustrated attempts by China and other emerging nations to revamp the existing international financial institutions to better reflect the shape of the global economy.

A key sticking point is the U.S.’s failure for more than four years to approve shifts in the IMF’s ownership structure, which would give emerging markets more influence and install China as the third-largest member nation, up from sixth.

‘Bad Blood’

“If the IMF were to sidestep the explicitly stated desire of China’s government to have the yuan included in the SDR basket, it would create more bad blood in an already contentious relationship regarding currency matters,” said Eswar Prasad professor of trade policy at Cornell University in Ithaca, New York, and senior fellow at the Brookings Institution in Washington. “A negative ruling on the yuan’s inclusion in the SDR basket could crystallize emerging market policymakers’ concerns that the IMF remains an institution run by and for the benefit of advanced economies.”

On China’s streets there are suspicions over the U.S.’s role in the IMF’s review. A failure for China to enter the SDR basket may be because the U.S. “doesn’t want to see the rising power of China,” said Beijing-based information technology worker Miu Jie, 29.

At the Central University of Finance and Economics in Beijing, student Daniel Min is taking the long view.

“If China wants to reach the goal of becoming a developed nation, it’s an indispensable step,” said Min, 21. “Power determines everything. China is already big enough that they have to pay attention to China’s concerns. The IMF will make the decision to put the RMB into the SDR basket sooner or later.”

(An earlier version of this story was corrected.)