The International Monetary Fund is close to declaring China’s yuan fairly valued for the first time in more than a decade, a milestone in the country’s efforts to open its economy that would blunt U.S. criticism of Beijing’s currency policy.

The fund’s reassessment of the yuan—set to be made official in IMF reports on China’s economy due out in the coming months—follows years of IMF censure.
Beijing’s management of the currency.

The IMF’s latest view undermines the Obama administration’s pressure on China over its management of the currency and could undercut congressional efforts to inject yuan concerns into pending trade legislation.

“It takes the rug out from under the feet of U.S. critics of Chinese currency policy,” said Eswar Prasad, a Cornell University economist and former China official at the IMF. “The U.S. relied to a significant extent on what was seen as the IMF’s objective assessment.”

The Obama administration disagrees with the IMF, maintaining a view that the yuan, also called renminbi, remains “significantly undervalued.”

The shift at the IMF comes as Beijing is increasingly challenging the established global order. In recent months, China has won broad support for its new Asian Infrastructure Investment Bank, an entity that would rival the World Bank, the IMF’s sister institution. China is also pushing plans to create a modern “Silk Road” by better connecting its economy with those in the rest of Asia, the Middle East, Africa and Europe. Chinese officials have asked the IMF to include the yuan in the elite basket of currencies that comprise the fund's emergency-lending reserves, a decision the fund will consider later this year.

The Washington-based IMF, which is the pre-eminent authority on currencies and exists in large part to independently monitor exchange rates among its 188 member countries, has long chastised Beijing for an undervalued currency. The fund’s judgment gave credence to years of U.S. accusations that China gave its companies an unfair competitive advantage by keeping the yuan’s value below a level suggested by market fundamentals.

U.S. lawmakers and the past three presidential administrations have alleged that China’s economic expansion came at the expense of American jobs, exports and growth, and dangerously distorted the global economy. With breakneck growth as an export powerhouse, China in recent years became the world’s second-largest economy after the U.S.

Now, after a decade in which the yuan has been allowed to appreciate by more than 30% against a basket of currencies, senior IMF officials say the exchange-rate value is roughly appropriate.

“We are now reaching a point where we are close to this no longer being undervalued,” Markus Rodlauer, deputy director of the IMF’s Asia department, said last month.
The IMF is expected to use its typically cautious and diplomatic style in characterizing the currency’s latest position, likely avoiding the term “fairly valued” in its official statements.

Mr. Rodlauer, for instance, said last month the currency is “moving towards equilibrium.” Thus, the fund’s official assessment could leave enough wiggle room to reverse course if China alters its policy and also remain vague enough to give critics room for skepticism.

The yuan is roughly pegged to the dollar, and as the U.S. currency has appreciated against most other major currencies, it has helped push up the value of the yuan. In nominal terms, the yuan’s appreciation has leveled off. But accounting for inflation, the value of the currency has risen by more than 10% in the past year alone.

As China’s economy cools, some economists don’t rule out Beijing depreciating the yuan again to help juice exports and prop up its expansion. That or other major changes to underlying economic fundamentals could still change the IMF’s early evaluation of the yuan. China’s economic growth slowed to 7.4% in 2014, downshifting to a level not seen in a quarter-century and firmly marking the end of a high-growth heyday.

Beijing has gathered the backing of a host of U.S. allies and fund officials have signaled IMF reserve-currency status for the yuan is only a matter of time. Some analysts say that effort is a key reason why China has curbed yuan intervention and fostered a stable currency in the past year.

The assessment of the yuan remains a deeply sensitive issue for the IMF. For several years, China wouldn’t let the fund publish an annual economic review of the economy in part because of criticism of the exchange-rate policy.

At the height of China’s bloated trade surplus in 2007, the U.S. Treasury Department fought a year-long battle with fund officials and the IMF’s biggest shareholders to get the fund to label the yuan “fundamentally misaligned.”

In 2008, just a week before a board meeting scheduled to tackle the controversial issue, the global financial crisis erupted with the Lehman Brothers...
bankruptcy. The meeting was canceled. Since then, Beijing has bulked up on U.S. government debt as Washington borrowed heavily to fight the crisis and stabilize the American economy.

The yuan’s appreciation in recent years has bolstered arguments from U.S. administrations to Congress to let the Treasury Department use diplomacy, rather than sanctions, to drive changes in trade partners’ currency policies. That message is being sent again as the Obama administration tries to dissuade lawmakers from including punitive currency-manipulation measures in pending trade legislation, efforts Treasury officials say could kill the pending Trans-Pacific Partnership, a trade pact among 12 nations that represent 40% of the global economy.

U.S. officials don’t accept the IMF’s assessment. “China’s exchange rate remains significantly undervalued,” Nathan Sheets, U.S. Treasury undersecretary for international affairs, said last week.

Mr. Sheets, echoing the Treasury’s recent semiannual report to Congress on the currency policies of major trading partners, said China’s rising trade surplus, falling oil prices, higher levels of productivity and the need to foster more domestic consumption mean the yuan should trade at higher levels.

Mr. Sheets, Treasury’s top financial diplomat, said the real test of Beijing’s commitment last year to curb currency interventions will be if authorities resist the temptation to depreciate the yuan amid those pressures on its currency.

Gauging the appropriate value of exchange rates is far from exact science given the number of variables at hand.

But two economic metrics long revealed the extent of Beijing’s currency intervention: trade and foreign-currency reserves. Fueled by a devalued currency, China’s trade surplus topped out at more than 10% of the country’s gross domestic product in 2007 and helped drive a U.S. trade deficit that averaged 5% in the years leading up to the financial crisis. As Beijing bought dollars, euros and yen to keep a lid on the yuan’s value, it built up a $4 trillion stockpile of foreign-exchange reserves, the largest in the world.

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China’s massive trade surplus has fallen since 2007 in part because of the yuan’s
appreciation, but also because global demand collapsed in the wake of the financial crisis. That raised concerns from some economists that if Beijing doesn’t move fast enough to an economic model more reliant on domestic consumption, China’s trade surplus could once again balloon.

The country’s trade surplus has since declined to around 2.5% of GDP, and currency interventions have fallen to a trickle by comparison, say IMF economists and outside experts.

“By both measures, it has become untenable to regard the renminbi as significantly, or even moderately, undervalued,” said Mr. Prasad, the former IMF economist. In fact, he said China is now propping up the value of the yuan to prevent it from falling, partly due to fear that it will be accused of depreciating its currency.

Zhu Haiquan, a spokesman for the Chinese embassy in Washington, said authorities will continue long-running plans to gradually allow the yuan to float more freely. “We will comprehensively push forward reform and opening up,” Mr. Zhu said.

Earlier last month, Chinese central banker Zhou Xiaochuan told the IMF’s policy committee that Beijing plans to roll out several policies this year that will make the currency more internationally usable.

Last year, the IMF targeted the yuan as “moderately undervalued” by 5% to 10%. Other countries, such a South Korea, Singapore and Malaysia, were also censured for exchange rates that didn’t reflect economic dynamics. But as the second-largest economy in the world, China’s undervaluation has had heftier consequences for the global economy.

Now, Germany has surpassed China as the world’s largest trade-surplus economy. Its trade surplus, projected by the IMF to hit 8.4% of GDP this year, would be the largest the European powerhouse has recorded in decades. That has moved Berlin into the cross hairs of the Obama administration, which says Germany’s economic policies undermine growth elsewhere in the 19-nation eurozone and blunts the global recovery.

Meg Lundsager, a former U.S. representative to the IMF’s executive board, said that while an IMF fair-value designation of the yuan would be a milestone in Beijing’s efforts to liberalize its economy, Chinese authorities still have a long way to go. “If China is really ready, why can’t it have a market-determined exchange rate and interest rate, and stop accumulating foreign currency reserves?” Ms. Lundsager asked. “That’s the real test.”
But Fred Bergsten, a former U.S. Treasury diplomat and a founder of the Peterson Institute for International Economics, said Treasury Secretary Jacob Lew faces risks from pressing China to allow greater currency flexibility.

Many economists say China’s weakening economy is likely putting downward pressure on the yuan. “Abandonment of their dollar peg at this time would probably lead to a significant depreciation, strengthening their competitiveness and trade surpluses with adverse effects on our economy,” said Mr. Bergsten, a longtime critic of Beijing’s currency policy.

That would likely reignite “congressional charges of manipulation and add further difficulty to passage of the pending trade legislation,” he said.

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