OPINION

The Limited Rise of the Yuan

By Eswar Prasad

The International Monetary Fund will officially anoint the yuan as an elite global reserve currency this Saturday. It will join the select basket of currencies (the dollar, euro, yen and pound sterling) that constitute the IMF's currency unit, the Special Drawing Rights. This is a symbolically momentous event, yet the future of the yuan as a major international currency that intermediates global trade and financial flows is far from assured.

The currency has so far been powered by China's economic growth, but will ultimately be held back by the failure of reforms.

According to the optimists, the yuan is reshaping global finance. With China's economy now the second-largest in the world and gradually catching up to the U.S., the days of the dollar's dominance are surely numbered. Rising levels of government debt and political dysfunction in the U.S. will only speed up the dollar's decline and the yuan's rise.

Pessimists point out that the yuan has had a rough ride over the past year. For several months, capital outflows put downward pressure on the currency, and the Chinese economy looks shaky. The currencies of developing nations inevitably suffer periods of volatility, and this will make the yuan unsuitable as a standard unit of exchange until China becomes wealthier.

As usual, the truth lies somewhere in the middle. While the yuan's internationalization is remarkable, the hype about the currency's inevitable rise to dominance is vastly overblown. The outcome ultimately hinges on how seriously the Chinese government follows through on its ostensible commitment to financial-market liberalization as well as to broader economic reforms.

The yuan has come a long way in a short period. Just a few years since China started easing restrictions on inflows and outflows of financial capital, the currency has come to play a significant role in the denomination and settlement of cross-border trade and financial transactions.

Remarkably, the yuan has also become a de facto reserve currency, even though China has neither an open capital account nor a flexible exchange rate. Many central banks around the world are gradually acquiring modest amounts of yuan assets for their foreign-exchange reserve portfolios.

The key challenge China now faces is the need for well-developed and

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better-regulated financial markets. Foreign investors, both private and official, need to be able to acquire and hold high-quality financial assets denominated in yuan.

Beijing is taking some of the necessary steps, trying to develop and strengthen its corporate and government-bond markets, while also giving foreign investors easier access to such instruments. Foreign investors remain unpersuaded. They remain skeptical about whether the government is serious, for instance, when it says that foreign investors can now more easily sell and repatriate their investments.

The only way to convince investors is to match words and commitments with actions on the ground, and to avoid any stalling or backtracking of reforms. If China adopts reforms that put its economy and financial markets on the right track, the yuan could one day rival even such reserve currencies as the pound sterling and the yen.

Even with such reforms, however, the yuan will soon reach its limits. While the Chinese leadership is pursuing modest financial liberalization and limited market-oriented economic reforms, it has unequivocally repudiated political, legal and institutional reforms. President Xi Jinping's government has rolled back freedom of expression, the rule of law and the independence of key institutions from government interference.

China might have rising economic clout, but without these broader reforms it will never gain the trust of foreign investors. While the yuan has the potential to become a significant reserve currency, it will not attain "safe haven" status as a currency investors turn to for safekeeping during crises.

Still, the yuan's rise to international prominence will change international finance, and even China itself, in many ways. China has adopted a unique playbook for promoting the yuan while trying to only gradually free up capital flows and the exchange rate.

This process has set in motion a set of forces that will be difficult to control. Trying to roll back or halt these reforms could expose the Chinese economy to even greater risks. For instance, the Chinese central bank's attempt in August 2015 to modestly free up the exchange rate only created more turmoil in currency markets.

Over the next few years, the yuan's rising importance in international finance could well serve as a catalyst for domestic reforms and also help in improving the stability of the international financial system. The yuan will continue to rise in global finance, but don't expect it to rule.

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