A burning question in international finance is whether China’s yuan should be inducted into the highly selective group of currencies that constitutes the International Monetary Fund’s reserve currency basket, known as the Special Drawing Rights (SDR). The group now includes only the U.S. dollar, euro, Japanese yen and British pound sterling. By the end of this year, the IMF will decide on the yuan’s fate.

This has far-reaching implications, but not, as many believe, because it will signal the yuan’s challenge to the dollar as the dominant global reserve currency. The yuan won’t become a safe-haven currency unless China undertakes the substantial political, legal and institutional reforms necessary to build trust among foreign investors. These changes are unlikely to happen anytime soon, so
the dollar’s position is secure for now.

But the IMF’s decision could effect China’s progress on banking and other market-oriented economic reforms. These reforms will determine whether China’s economy gets on a better, less-risky growth path. If China’s reforms stall, global markets will feel the pain.

Chinese leaders have lobbied for inclusion in the SDR basket. Perhaps they hope to free themselves from reliance on the U.S. dollar by elevating the yuan, but the more immediate endgame is their domestic economy. Economic reformers in China have built public support around the idea that the yuan’s status in global finance should match China’s size and prominence in the world economy.

For the yuan to become a major international currency, China needs a raft of domestic reforms. These include a better and well-regulated banking system and a broader range of financial markets, including basic currency derivatives, fewer restrictions on capital flows and a truly market-determined exchange rate. Such reforms would improve financial markets and the allocation of resources in the Chinese economy, yielding more balanced and sustainable growth.

But there is fierce opposition to these reforms, which challenge vested interests that have enormous political clout. The government has used globalization of the yuan as a rallying cry to overcome this opposition and push forward with reforms.

The People’s Bank of China has already committed to fully freeing up interest rates on bank deposits in 2015. This will increase competition for deposits, driving up rates and benefiting savers. Small banks will be able to compete more effectively with large banks. Large banks oppose these reforms, but the PBOC has noted that market-determined domestic interest rates are an important criterion for the yuan’s inclusion in the SDR basket.

In principle, this entire debate is a nonstarter. Since the yuan isn’t freely convertible and its exchange rate isn’t fully market-determined, it is technically not a viable reserve currency. But this matter is more about international geopolitics than economics.

For the IMF, however, the decision is a matter of its own long-term survival. The IMF has had a contentious relationship with China on currency matters, and ignoring China’s explicit desire to join the SDR would create more bad blood.

The agency also wants to avoid another knock on its legitimacy, already tainted
by the lack of progress on giving emerging markets their rightful voting shares. Excluding the yuan from the SDR could crystallize the concerns of policy makers in emerging markets that the IMF remains an institution run by and for the benefit of advanced economies.

The IMF’s imprimatur would certainly help, but ultimately market forces will drive the yuan to be adopted as a reserve currency. Foreign investors, including foreign central banks, will hold the yuan if they are convinced of its worth. Unless China develops its financial markets, the IMF’s seal of approval won’t do much for the yuan’s stature.

The U.S. government should welcome the yuan’s claims to reserve-currency status. After SDR inclusion, China’s central bank would find it harder to manage or manipulate the value of its currency to gain a competitive edge for its exports. China will also have more reason to maintain the primacy of the IMF, where the U.S. has considerable influence, in international finance. And China’s financial market opening could create opportunities for U.S. firms, from banks to insurers.

The yuan’s inclusion in the SDR basket might be premature on technical grounds but is timely given its broader ramifications. A positive outcome would be good for China, the U.S. and the international monetary system. There is no good reason to delay.

Mr. Prasad is a professor in the Dyson School at Cornell University, senior fellow at the Brookings Institution and former head of the IMF’s China Division.

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