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IMF's yuan inclusion signals less risk taking in China

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When the International Monetary Fund agrees on Monday to add the Chinese yuan to its reserves basket in the biggest shake-up in more than three decades, the IMF can afford itself a congratulatory nod.

By acknowledging the yuan as a major global currency alongside the dollar, euro, yen, and pound, as is widely expected, IMF members will endorse the efforts of China's economic reformers and by doing so hope that will spur fresh change in China.

But Chinese policy insiders and international policymakers say reforms may not continue at the breakneck pace of recent months. In addition, Chinese sources suggest adding the yuan to the IMF basket leaves economic conservatives better positioned to resist further significant reform in a reminder of the period following China's entry to the World Trade Organization (WTO).

A slowing in the pace has implications for those who bet that making the yuan a global reserve currency will give it a boost. The yuan has fallen almost 3 percent against the dollar this year, on course for its biggest annual fall since its landmark 2005 revaluation.

The IMF decision will remove a key incentive – bolstering national pride – that reformers used to push otherwise reluctant conservatives to support reforms.

More importantly, however, are worries in Beijing that the rickety economy can't handle more aggressive reform that allows a freer flow of currency across China's borders.

Beijing is already rapidly losing a taste for more experimentation with capital flows, say the sources - economists involved in policy discussions who declined to be identified because of the sensitivity of the subject.

After the stock market buckled more than 40 percent in the summer – which many blamed on nefarious foreign capital – regulators have made it harder for money to leave China to counter yuan selling pressure and have intervened heavily in onshore and offshore currency markets. Not just conservatives, but more liberal economists are calling for a pause.

"Our ability to control financial risk has yet to be improved," said a senior economist at the China Centre for International Economic Exchanges (CCIEE), an influential Beijing think-tank.

"Any rush to open up the capital account completely could be unfavorable for controlling financial risks ... we will definitely be very cautious."

The IMF's executive board, representing the Fund's 188 members, is likely to approve inclusion of the yuan in the reserve basket, known as Special Drawing Rights (SDR). An IMF staff report and Managing Director Christine Lagarde have endorsed the idea. The United States has suggested it will not stand in the way.

The SDR basket determines the currency mix countries like Greece receive when the IMF disburses financial aid. Some economists predict inclusion will boost demand for the yuan, or renminbi (RMB), by more than $600 billion.

Chinese media predicted entry will draw over 1 trillion yuan ($156 billion) of foreign money into China bonds. Both predictions rest on assumptions more capital account opening is on the way.

"The RMB (will be) included so the reform-oriented forces can keep the upper hand; there's no way back now for the conservative members in the party," said an IMF policymaker from an advanced economy, who spoke on condition of anonymity.

Seeing the SDR decision as the goal of China's reforms is "as if the tail were wagging the dog," said Otaviano Canuto, who represents Brazil and other Latin American and Caribbean countries on the IMF board.

"The expectation is that the eventual inclusion of the RMB is a moment in the process ... (which) is being undertaken and implemented for itself, because it's part of the development of the Chinese economy," he said.

"WHY WOULD YOU TAKE MORE RISKS?"

China has pushed to make the yuan more international, setting up swap arrangements with countries so trade can be settled in the currency and China has said it will push ahead with financial reform. It has widened the yuan's trading band and this year went a long way to freeing up interest rates.

But Chinese policy advisers have always been divided, sometimes publicly, on how far China should go in opening up its borders to foreign capital; while few use vocabulary that rejects general reform principles, many domestic policy advisors - including some otherwise supportive of economic liberalization - warn throwing open the gates to cross-border flows would be destabilizing.

They have many quiet allies among China's state-owned banks and other inefficient industries, which fear that a freer market for capital will expose them to international competition and put them out of business.

Foreign access to financial markets is still tightly restricted and of late regulators have reversed some measures that were designed to make it easier to move the yuan offshore.

"The (Chinese) reform camp has been selling (IMF inclusion) partly on the basis of international prestige, in particular equaling Japan," said Derek Scissors, chief economist at China Beige Book.

"What is the reform movement going to say now to move reform forward ... if the IMF has already recognized China as an internationalized currency?" asked Scissors. "Why would you take more risks?"

Some see parallels with China's WTO entry in 2001, in which Chinese reformers used entry negotiations as an incentive to push through painful state sector restructuring, only to see their agenda sidelined shortly after inclusion.

China's retreat from its WTO commitments was widely blamed on the retirement in 2003 of reform-minded Premier Zhu Rongji. Current leading reformer Zhou Xiaochuan, the head of the central bank who has said the yuan will be basically convertible by this year, is at 67 years old already past the typical retirement age for senior Communist Party officials.

"Previous wording was 'accelerating' convertibility, now it's 'making RMB convertible in an orderly manner,'" said an economist, of the China Academy of Social Sciences (CASS), who is also close to policy discussions. He said China was well aware capital account liberalization elsewhere - in particular Japan - has been blamed for causing "serious crises."

"The most important thing is to handle domestic issues well; we cannot afford to see another collapse of the stock market."

(Additional reporting by Kevin Yao in HONG KONG; Editing by Neil Fullick)