BEIJING—China’s central bank devalued its tightly controlled currency, causing its biggest one-day loss in two decades, as the world’s second-largest economy continues to sputter.

Chinese authorities said the change would help drive the currency toward more market-driven movements. The move also signaled the government’s growing worry about slow growth. A shift toward a weaker currency could help flagging exports at a time when many other efforts to boost the economy haven’t proven very effective.

China’s yuan has been on an upward track for a decade, during which the country’s economy grew to be the second largest in the world and the currency gained importance globally. The devaluation Tuesday was the most significant downward adjustment to the yuan since 1994, when as part of a break from Communist state planning, Beijing let the currency fall by one-third.

China sets a midpoint for the value of the yuan against the U.S. dollar. In daily trading, the yuan is allowed to move 2% above or below that midpoint, which is called the daily fixing. But the central bank sometimes ignores the daily moves, at times setting the fixing so that the yuan is stronger against the dollar a day after the market has indicated it should be weaker.
With Tuesday's move, the fixing will now be based on how the yuan closes in the previous trading session. As a result, the yuan's fixing was weakened by 1.9% Tuesday from the previous day, leaving it at 6.2298 to the U.S. dollar, compared with 6.1162 on Monday. The yuan dropped as much as 1.99% from its previous close to 6.3360 against the dollar in Shanghai and fell as much as 2.3% in Hong Kong in early trading.

The central bank said in a statement posted on its website that the yuan’s midpoint has diverged quite a bit from the market rate for a relatively long time and that it was time to make the midpoint more market-based.
“The PBOC has astutely combined a move to weaken the yuan with a shift to a more market-determined exchange rate,” said Eswar Prasad, a Cornell University professor and former China head of the International Monetary Fund.

China’s leadership has been urging the IMF to declare the yuan an official reserve currency on par with the dollar, euro, the Japanese yen and the British pound—a move that could raise China’s influence on the world stage just as Beijing increasingly challenges Washington in global affairs.

To that end, the leadership has been resisting an outright devaluation of the currency despite the country’s plunging exports, for fears that a move like that could jeopardize the yuan’s chance of joining the elite group of currencies.

Rather, it chose to do so by giving what the longtime critics of China’s currency policy have long been clamoring for: Let the market play a bigger role in deciding the yuan’s value.

The engineered fall in the yuan is likely to cause political ripples around the world. In particular it may reignite criticism of China’s tight control over the yuan’s exchange rate within the U.S. Congress and some American businesses, which have long said the currency was already too weak and set at a rate that allowed Chinese exporters to sell their goods artificially cheap on world markets.

As recently as April, other central bankers were speaking confidently that China wouldn’t devalue. This puts pressure on them to follow suit. China’s currency move also could pose a challenge for the U.S. Federal Reserve. The Fed is preparing to raise U.S. interest rates later this year. One source of concern for the Fed this year has been a strong U.S. dollar, which is squeezing exports and helping to hold U.S. inflation below the Fed’s 2% target. China’s move puts more upward pressure on the dollar, which could be exacerbated further when the Fed actually raises rates.

In a semiannual report about world currency exchange rates published in April,
China’s Summer of Economic Woe

The “new normal” China’s leaders have trumpeted turned into a tornado of stock-market turmoil and other challenges in recent months that on Tuesday led Beijing to engineer its biggest currency devaluation in two decades to arrest slowing growth. Here are some of the major moments.

(Source: WSJ Research)

May 15
China’s central bank and other agencies tell banks to lend more (http://www.wsj.com/articles/china-stimulus-aims-at-restructuring-trillions-in-local-government-debt-1431511027) to indebted local governments and allow them to swap trillions of dollars in loans for newly issued

After high-level talks with Chinese officials in June, U.S. Treasury Secretary Jacob Lew said China agreed to intervene in foreign-exchange markets “only when it's necessitated by disorderly market conditions and will consider additional measures to transition to a market-oriented exchange rate.”

Still, U.S. officials, who had objected to the IMF’s latest assessment of the yuan, considered that a narrow victory given China’s considerable latitude in determining what constituted “disorderly conditions.”

“The real test is going to be, when there’s upward pressure on the [yuan], will China refrain from intervening?” Mr. Lew said at the time. “And that is still an open issue.”

The news comes weeks before China’s President Xi Jinping is due to visit Washington for a summit with U.S. President Barack Obama, who has resisted calls to describe Beijing as a currency manipulator during his time in office but
is now likely to face new pressure on the currency question.

China’s decision to allow the yuan to depreciate is likely to create an outcry in Congress as the presidential-election season heats up, said Conference Board economist Andrew Polk. While China has taken the step for domestic reasons, that is unlikely to stop a divided Congress from reacting, he said. “It’s going to be a headache. Donald Trump is going to have a field day with this,” he added, referring to the real-estate developer and Republican presidential candidate.

The devaluation on Tuesday comes just over 10 years after China began a process that sharply lifted the value of its currency, and which together with other efforts to restructure its exchange rate helped make the yuan one of the most actively used currencies in Asia.

On July 21, 2005, China surprised global financial markets by saying it would remove a hard peg that for over a decade had valued the U.S. dollar at 8.28 yuan. The People’s Bank of China’s initial 2.1% move in 2005 pushed the dollar down to 8.11 yuan, and the yuan kept rising in subsequent years. By yesterday’s market close in Shanghai trading, the U.S. dollar bought 6.2097 yuan, meaning the Chinese currency had risen about 33% against the dollar during the decade.

Tuesday’s move could give a shot in the arm to China’s weakened exports sector,
which remains an important part of the economy despite Beijing’s effort to seek growth beyond its traditional sources. On Saturday, Chinese officials said July exports fell a surprising 8.3% from a year earlier. Exports for the first seven months of the year were down 0.8% in dollar terms compared with a year earlier.

The strong exchange rate against the euro has been a drag on China’s exports. The PBOC has kept the yuan steady against the dollar but doesn’t as regularly influence its exchange rate against other currencies, allowing the yuan to follow the dollar’s rise against other currencies like the euro. The latest data showed exports to the European Union fell 12% in July from a year ago.

China’s economic growth in the second quarter came in at 7% year over year, the slowest pace in six years, due to a weak property market and soft domestic demand in addition to exports. China’s cabinet, the State Council, said last month it would offer tax breaks and other incentives to help the trade sector. Other measures Beijing has taken include four rate interest-rate cuts since November to provide funds for

1. January 1994

China consolidates its competing exchange rates into a single one pegged to the U.S. dollar. Before that, China had an official rate and a rate offered domestically at what were known as swap centers. It comes amid a slew of other reforms intended to shake up the country’s underperforming state-owned enterprises and make the economy more market-focused.
domestic companies.

The currency action raises questions about whether China will be able to pull off its shift to an economy oriented toward domestic demand and away from export-led growth.

“The real proof in whether this change is about reform or growth will come when authorities resist the urge to intervene down the road when another policy goal that could be achieved by a significant revaluation or devaluation comes knocking,” said Scott Kennedy, an analyst at the Center for Strategic & International Studies, a Washington think tank.

“China wasn’t able to resist that urge on the stock market, so the government doesn’t get the benefit of the doubt on this quite yet,” Mr. Kennedy said, a reference to China’s recent moves to prevent further declines in its equities markets.

China shares wavered between positive and negative territory after the announcement, a day after Shanghai posted its largest daily percentage gain in a month. The Shanghai Composite Index was last flat at 3929.26 while the smaller Shenzhen market was up 0.7% at 2290.

**Write to Lingling Wei at lingling.wei@wsj.com**