OPINION | COMMENTARY

Market Discipline Remains Elusive in China

Making the yuan more responsive to market forces means little without the support of a strong institutional framework free of government intervention.

CONTROL STREAK: People's Bank of China's governor, Zhou Xiaochuan. *PHOTO: EUROPEAN PRESSPHOTO AGENCY*

By **ESWAR PRASAD**

Aug. 18, 2015 1:37 p.m. ET

China has once again turned desperation into opportunity. The central bank has made the best of a difficult moment, tying a devaluation of the yuan with another step toward increasing the flexibility of the exchange rate. Who can argue with a move toward greater liberalization, even if the circumstances might not be ideal? But without broader institutional reforms, China's currency and economy will likely both stall.

Before last week's devaluation, the People's Bank of China apparently felt cornered, with its monetary-policy instruments failing to boost domestic demand and a currency riding high on the coattails of the strong U.S. dollar, thereby hurting Chinese exports. So the PBOC joined the parade of central banks, in advanced economies and emerging markets alike, using currency policy to protect export competitiveness and prop up domestic growth.

Such a foray into the currency wars will raise howls from foreign governments and international institutions seeking to preserve order in global finance. But the PBOC has deftly blunted foreign criticism by coupling its devaluation with steps to further tie the currency's value to market forces. More important, the central bank has given itself greater freedom to focus monetary policy on domestic reform objectives rather than on maintaining an artificially stable currency value relative to the dollar.

For all the troubles wracking the Chinese economy, policy makers are continuing—in their typical piecemeal, gradual manner—to pursue important reforms. The government is making slow but steady progress toward removing restrictions on capital inflows and outflows, liberalizing the interest rate on bank deposits, and now allowing for more exchange-rate flexibility. Just last week Beijing freed up the interest rate paid by commercial banks on certificates of deposit, another step toward interest-rate liberalization.

These reforms will benefit China's economy in the long run. They will also strengthen China's case for the yuan to be included in the International Monetary Fund's basket of Special Drawing Rights, which would count as the IMF's official imprimatur that the yuan has attained reserve-currency status.

Yet these reforms will have limited traction domestically and internationally unless China's government is willing to cede control and undertake broader efforts affecting more fundamental aspects of state control. A broader set of financial markets, including vibrant exchange of government and corporate bonds, is a prerequisite for effective resource allocation.

As long as the state acts as a safety net for state-owned enterprises and financial institutions, real market discipline will remain elusive. As recent stock-market volatility has demonstrated, market-oriented liberalization without the support of a strong institutional framework can yield greater volatility and more costs than benefits.

In the case of the boom-bust cycle that has whiplashed China's stock market, the government made matters worse by ricocheting between its desire to let the market discipline itself and its urge to maintain control and stability. Improvements in corporate governance, accounting standards and transparency of corporate audits—rather than more forceful government intervention—would make China's stock market more stable.

Concerning the yuan, it is important to recognize that the power of a currency in international finance comes not just from the size of the economy behind it, but also from the institutions that back it up. Independent courts, an independent central bank and a political system with the ability to self-correct are all essential. Reforms to cultivate such institutions in China are necessary to allow other market reforms to achieve their objectives of high, balanced and stable growth.

Such long-term goals may seem far removed from the many challenges facing China's government right now. But as Chinese leaders proceed with financial and other economic reforms, the lack of strong and independent institutions will at best hamper their progress, and at worst heighten uncertainty and volatility across the economy.

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