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China resumes interest rate liberalization

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Executive Summary

In the first half of 2012, Chinese financial reform progressed faster than previously anticipated, with a proposed capital account liberalization timeline released in February, the renminbi's trading band widened in April for the first time in five years, and interest rate liberalization resuming in June after an eight-year hiatus.

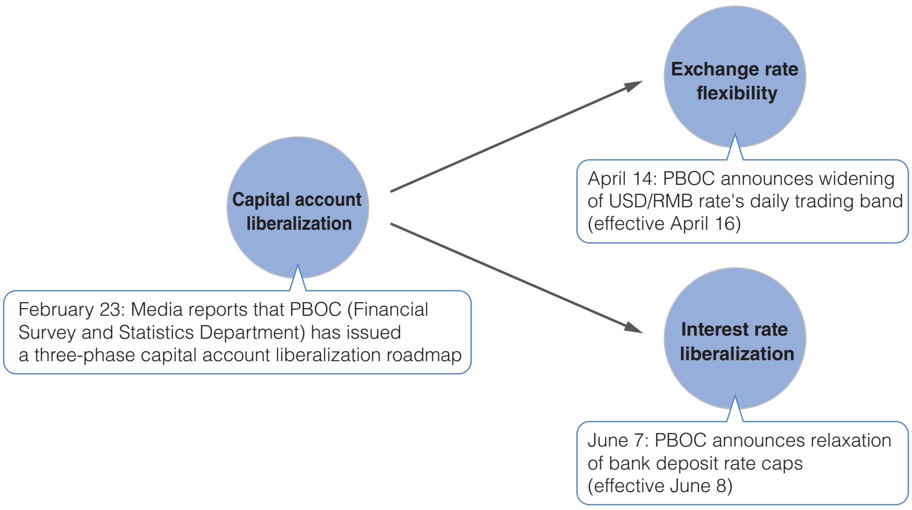
Interest rate liberalization resumes after 8 year hiatus

China's ongoing financial reforms were expected to proceed apace in 2012 irrespective of this autumn's leadership transition, but they progressed faster than anticipated in the first half of the year (Exhibit 1).

In February, the People's Bank of China (Financial Survey and Statistics Department) unveiled a proposal to liberalize China's capital account in three phases over the next 10 years[1]. Capital account liberalization involves exchange-rate flexibility (if China is to maintain domestic monetary policy latitude). It also hastens interest rate liberalization, as exemplified by Japan's experience in the 1980s. In fact, the PBOC's proposal stated that if China were to wait until

NOTE
1) http://www.nri.co.jp/english/opinion/lakyara/2012/pdf/lkr2012138.pdf

Exhibit 1: Chinese financial liberalization in first half of 2012



Source: NRI

conditions were perfectly ripe for interest rate and exchange rate liberalization and renminbi internationalization as a prerequisite for capital account liberalization, it would end up waiting forever. The PBOC thus signaled its intent to carry out capital account, exchange rate, and interest rate liberalization simultaneously.

Against such a backdrop, the PBOC announced on April 14 that it would widen the renminbi's daily trading band (based on the USD/RMB midrate[2)]) from 0.5% to 1.0%, effective from April 16. It was the trading band's first enlargement in five years. With the move, Chinese authorities demonstrated their willingness to steadily increase exchange rate flexibility in the aim of capital account liberalization, based on a recognition that the renminbi was recently trading near its equilibrium level and unlikely to move sharply in either direction even if its trading band is widened.

2) Published by the China Foreign Exchange Center

Next, China resumed interest rate liberalization. The PBOC did so while cutting benchmark lending rates twice, on June 8 and July 6. Specifically, effective from June 8, the PBOC (1) raised its caps on bank deposit rates to 110% of the corresponding benchmark rates (the caps were previously set at parity with corresponding benchmark rates) and (2) lowered its bank lending rate floors to 80% of corresponding benchmark rates (from 90% previously). On July 6, it again lowered its bank lending rate floors, this time to 70% of corresponding benchmark rates (Exhibit 2).

China first embarked on interest rate liberalization in 1996, starting with the

Exhibit 2: Recent benchmark interest rate levels

(%)

	July 6		June 8		Before June 8
Deposit rates	BMR	Cap (1.1x BMR)	BMR	Cap (1.1x BMR)	
Demand deposits	0.35	0.385	0.40	0.440	0.50
Term deposits					
3 months	2.60	2.860	2.85	3.135	3.10
6 months	2.80	3.080	3.05	3.355	3.30
1 year	3.00	3.300	3.25	3.575	3.50
2 years	3.75	4.125	4.10	4.510	4.40
3 years	4.25	4.675	4.65	5.115	5.00
5 years	4.75	5.225	5.10	5.610	5.50
Lending rates	BMR	Floor (0.7x BMR)	BMR	Floor (0.8x BMR)	
6 months	5.60	3.920	5.85	4.680	6.10
1 year	6.00	4.200	6.31	5.048	6.56
1–3 years	6.15	4.305	6.40	5.120	6.65
3–5 years	6.40	4.480	6.65	5.320	6.90
Over 5 years	6.55	4.585	6.80	5.440	7.05

Note: BMR: benchmark rate
Source: NRI, based on PBOC data

interbank call rate. During the remainder of the 1990s, it continued to liberalize interbank rates. In liberalizing financial institutions' interest rates, China has been proceeding from lending rates to deposit rates, from foreign currency deposit rates to renminbi deposit rates, from long-term rates to short-term rates, and from large deposit rates to small deposit rates. In pursuing full liberalization, China set an interim target of regulating deposit rates by means of rate caps and lending rates by means of rate floors. It achieved this target in October 2004, when it abolished lending rate caps. At that time, lending rate floors were set at 90% of corresponding benchmark rates and deposit rates were capped at parity with corresponding benchmark rates. Subsequently, the lending rate floors and deposit rate caps basically remained unchanged until June 2012. The aforementioned 2012 measures marked the resumption of interest rate liberalization after a nearly eight-year hiatus.

The recent resumption of interest rate liberalization was prompted by Chinese monetary authorities' plan to expedite financial liberalization as described above. Another factor that cannot be overlooked is de facto interest rate liberalization in the markets, not only in the informal finance (peer-to-peer lending) sector but also in the form of high-interest trust products sold through banks. In 2011, the authorities' monetary tightening was diluted by financial disintermediation and banks' off-balance-sheet activities. In other words, financial deregulation is to some extent playing catch-up to de facto interest rate liberalization.

Banks' lending margins have started to shrink

Banks' net lending margins have tightened following the PBOC's June and July rate cuts and deposit rate cap hikes.

After the June deposit rate cut, large state-owned banks' rates on term deposits with maturities of up to 12 months have remained roughly unchanged from previously. Mid-sized banks, by contrast, raised their rates on term deposits of up to 12 months to the maximum allowable level (110% of benchmark rate). As a result, their rates on such term deposits are higher than before the PBOC's June rate cut. Some regional banks have maximally raised rates on term deposits with maturities of two years and longer also.

After the PBOC's July rate cut, large state-owned banks are paying 3.25% interest

(108% of new benchmark rate) on 12-month term deposits, unchanged from before the rate cut. On term deposits of two years and longer, they are paying the equivalent of the new benchmark rates. Mid-size banks are likewise paying the equivalent of the new benchmark rates on term deposits of two years and longer, but they have set their rate on 12-month term deposits at 3.3%, the maximum allowable rate. If banks lower their lending rates to the rate floor of 70% of the benchmark rate, they would not earn much more than they could by lending in the call market. When other costs are factored in, banks look likely to have difficulty lending profitably at these interest rate levels[3).

3) This paragraph and the preceding one are based on Chinese media reports, most notably an article entitled "17 banks raise deposit rates; private-sector banks now pay higher rates than state-owned banks" in the July 7 Beijing News.

The recent series of measures to expedite financial liberalization, including the moves to further liberalize interest rates, will likely force banks to change how they do business by compressing spreads between deposit and lending rates. Chinese banks likely face challenges similar to those encountered by Japan's banking industry in the latter half of the 1980s. Capital market reforms, particularly those aimed at developing bond markets, a priority objective of the authorities' reform agenda, will make it easier for large corporations to borrow directly from capital markets. Going forward, banks may reorient their lending operations toward small and mid-sized companies from which they can earn fatter lending margins. They may also place more priority on fee businesses. High-margin (i.e., high-risk) lending will test banks' credit management and risk assessment capabilities[4)].

4) Japanese banks' missteps with respect to credit management and risk assessment in the latter half of the 1980s led to nonperforming loans to nonbanks and real estate sector.

In terms of regulatorily mandated risk management, the authorities decided in June that the Chinese version of Basel III, originally scheduled to be adopted from January 2012, will take effect from January 1, 2013, in the form of a pilot commercial bank capital management framework. China will likely need to also introduce deposit insurance before it steps up interest rate liberalization in earnest.

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