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Interest rate liberalisation in China – necessary, but risky

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China is moving fast: Under the leadership of Premier Li Keqiang, the rate of reform in the Chinese financial system has increased considerably. The minimum lending rate was raised back in the summer of 2013, and the imminent authorisation of China's first five privately owned banks was announced in March. However, these steps along the path towards a market-oriented financial system are small when compared with the centrepiece of the reform agenda – the liberalisation of deposit rates, which is expected within the next two years.

Real deposit rate near zero

Until now, interest on bank deposits in China has been limited to no more than 10 % above the benchmark rate set by the central bank. This has meant that over the last ten years Chinese savers have only just avoided monetary depreciation through inflation, as shown by the graph. This level is well below the return on capital in the exceptionally dynamic Chinese economy.

Consequently, deposit rates are expected to rise once they are liberalised. This measure has far-reaching significance: it has a key role to play, both in reshaping China's growth model and in correcting distortions within the financial sector.

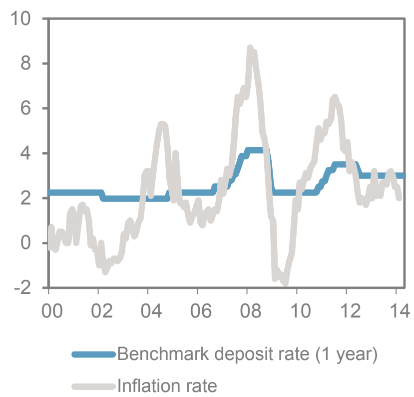
Higher interest rates increase consumption

One might at first assume that higher interest rates would provide an increased incentive to cut back on consumption spending. However, in all probability the opposite will happen. This is because of the following three mechanisms. (1) If bank deposits earn higher interest, household incomes rise. (2) In addition, a given wealth targetcan be achieved even at lower levels of saving. (3) Finally, the banks' higher funding costs would be passed on to borrowers in the form of higher borrowing rates. If the incentives for capital-intensive investments were to fall as a result, growth prospects would improve in labour-intensive sectors of the economy. This would result in higher wages, which would in turn have a positive effect on household incomes.

Higher interest rates attenuate distortions in the financial system

Because deposit rates are kept artificially low, the banks' funding terms are extremely favourable. This has put them in a position to provide low-cost loans, especially to large state-owned enterprises. This has led to a rapid climb in China's debt level, which is now estimated at over 200 % of GDP. Corporate debt, in particular, which stands at almost 150 % of GDP (source: BIS), is worryingly high. Only a few industrialised countries exceed this level, and none of the other major emerging markets comes anywhere close to it.

Figure: Interest on Chinese bank deposits [as percentage]



Source: Datastream

Over recent years, low deposit rates have become a problem for the banks themselves. In the hunt for returns, Chinese deposits have been rushed into alternative investments. This has exposed the banks to a constant leakage of resources, bringing with it increasing liquidity bottlenecks. Fresh competition from online money market funds has therefore been causing disquiet among institutions. The most widely known of these, Yu'E Bao, succeeded in gaining 81 million customers in its first nine months.

Since the financial crisis, new forms of financial intermediation outside the banking system have been growing rapidly: for example, the volume of investment trusts grew by 46 % in 2012 and now stands at yuan 10.9 trillion (approx. 20 % of GDP). Wealth management products and corporate bonds, which offer much higher returns, have also proved attractive. However, this part of the Chinese financial system, which is also often described as the shadow banking sector, is far less regulated and the quality of its assets is questionable. One sign of this is provided by reports of defaulting investment trusts at the beginning of the year.

Risks of interest rate liberalisation

Although interest rate liberalisation is necessary, it is not without risks. The banks' margins will come under pressure, at a time when income is urgently needed to offset rising credit risks. Moreover, history shows us that liberalisation in the financial system is often followed by financial crises. In order to avoid this, the removal of interest rate controls must form part of a coherent package of measures. Plans to introduce a deposit guarantee system in the near future represent an important step in this regard. ■