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China: Interest rates set free

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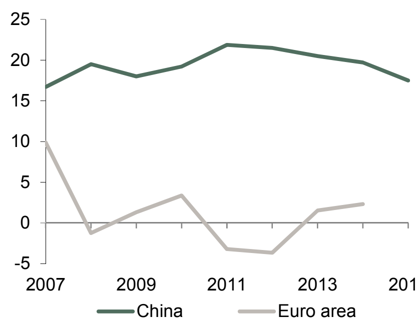
When announcing its latest key interest rate reduction on 23 October, the Chinese central bank (PBOC) also heralded an important change: the abolition of the interest rate ceiling on savings accounts. Although this was hardly a major step in its own right, having been hinted at for quite some time, it does have a number of important implications.

Banks finally free to set their own interest rates

Limits on banks' freedom to set loan interest rates were abolished in 2004 (upper limit) and 2013 (lower limit). From now on, however, they are completely free to set both lending and savings rates. This measure also takes into account the requirements arising from China's desire to free up its financial markets and the work it has already begun to restructure its economy, with a view to making it less investment and export-driven. The previous cap on savings interest enabled banks to attract cheap deposits and to provide loans at correspondingly low rates of interest, thus financing the investment boom. All the while, margins remained at consistently high levels, ensuring banks achieved a comfortable return on equity (Figure). Private individuals were less fortunate, however, making very little return on their savings. But now a world in which interest rates are set by the state is a thing of the past. Now, at least, there is a possibility that banks will have to compete for depositors via the interest rates that they set, which was previously only the case within the risky shadow bank sector. Higher bank interest rates will allow consumers to put less aside in future to achieve their savings objectives, thus giving them more to spend. And that is exactly what is intended. Greater flexibility for banks brings with it a need for greater responsibility on the lending side of the balance sheet, as banks will now have to price their loans in line with the degree of risk involved. A natural consequence of this is that banks will wish to avoid inefficient investments, thus improving allocation of capital.

Figure: Return on equity in the banking sector

Per cent



Source: Bloomberg, CEIC, ECB

Benchmark interest rates less important

Giving up control of lending and savings rates will have consequences for the PBOC's key interest rate policy. Previously, one-year benchmark rates for savings and loans were right at the heart of the various instruments / key interest rates at the PBOC's disposal. The upper and lower limits of lending and savings rates resulted directly from the setting of the official benchmark rates. With these limits now abolished, the benchmark rates on which they were based are also fundamentally less important. The PBOC will continue to publish them for the time being. Their role in future will depend substantially on the extent to which the major state-owned banks, in particular, feel free to break away from the benchmark rates when setting their own rates. Over time, it is likely that these benchmark interest rates will function as key interest rates to a much lesser extent.

Another important instrument in Chinese monetary policy has been the minimum reserve ratio for major banks. While minimum reserve ratios are also significant in the monetary policies of industrialised nations, their significance lies simply in the very fact of their existence. It is unusual for the ratios to change, in contrast to the position in China where the PBOC uses minimum reserve ratios as an active instrument of monetary policy. As financial market liberalisation takes hold in China, the PBOC can also be expected to adapt the contents of its monetary policy tool box to those familiar in the Advanced Economies, one of the consequences of which in the longer term might be less frequent changes to the minimum reserve ratio.

Money market rates to become more important

Instead, money market rates will play a more important role. The PBOC has created a number of instruments in the recent past that point in this direction but which have not so far been given a central role. These instruments are, on the one hand, (genuine) repo transactions (sales and purchases of securities with repurchase agreements) and, on the other hand, three different lending facilities (LFs) – very like secured loans in nature – that are often also referred to as repos. In the longer term the interest rates payable on these (so far, rather infrequently used) LFs could assume a similar role to that of key interest rates. It is also conceivable that the PBOC might follow the example of the US Federal Reserve in setting an interest rate target for inter-bank money market trading, seeking to achieve this via its repo policy. In any event, we should prepare ourselves for the fact that the monetary policy that has operated in China up to this point will be replaced in the longer term by one that focuses much more on money markets, with repo rates or money market rates taking on the role of key interest rates. ■