CHINA's ECONOMY & POLICY

Insiders' insights

Direction for Interest Rate Liberalization

China's Economy & Policy (CEP) *places unparalleled knowledge and insider expertise at your finger tips. It provides critical economic and industry analysis, policy insights and expert advice to support business decision-making in China. Please visit www.china-economy-policy.com or write to CEP@thegateway-group.com for more information.*

published by Gateway International

July 2012
- *Single report edition*

Strategic Partner
- *Research Base for Industrial Finance (RBIF), Chinese Academy of Social Sciences (CASS)*

Chief Economist
- **YANG Tao**, *Director General, RBIF*

Executive Editor
- **G. Bin ZHAO**

CHINA's ECONOMY & POLICY

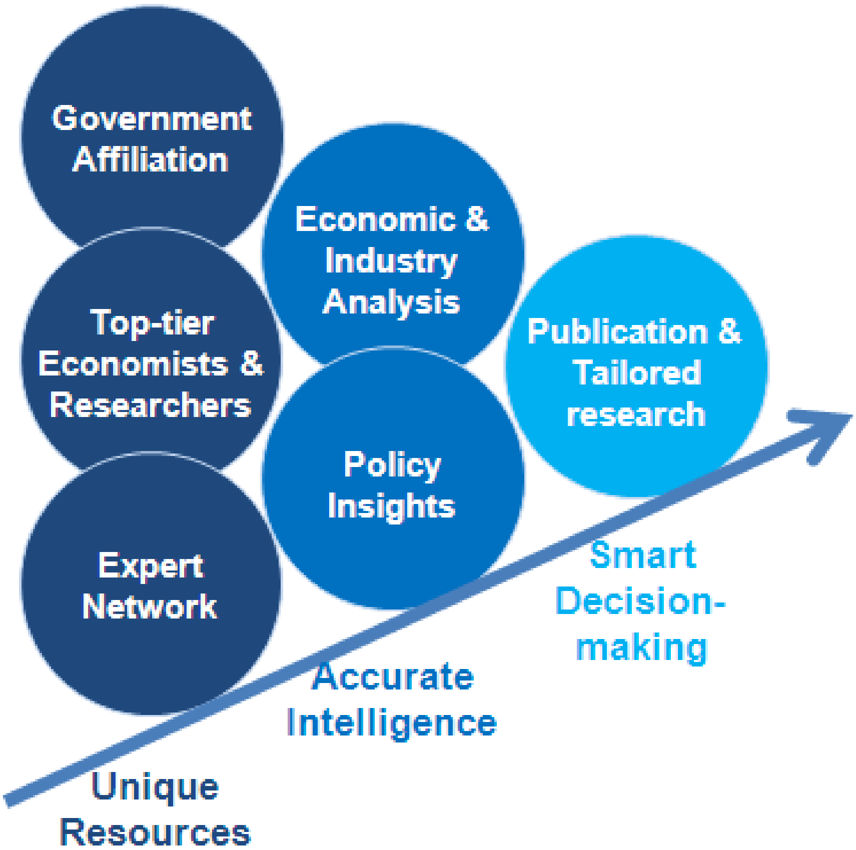
Insiders' insights

the Advisory Board

China
- **LI Yang,** *Vice President, CASS, a deputy minister level position; former member of the Monetary Policy Committee of People's Bank of China*
- **WANG Guogang,** *Director General, Institute of Finance & Banking, CASS*
- **JIN Bei,** *Director General, Institute of Industrial Economics, CASS*
- **Shamus MOK,** *Former Director, McKinsey Knowledge Center China;*
- **WANG Fei,** *China Banking Regulatory Commission*

International
- **Ilan ALON,** *Director of The China Center, Rollins College; Visiting Scholar & Asia Fellow, Harvard Kennedy School*
- **Fernando BENSUASKI,** *Managing Director, Goshawk Strategies; Chenco Holdings*
- **Alberto FORCHIELLI,** *Managing Director, Mandarin Capital; former professor, the University of Bologna*
- **Alicia GARCIA-HERRERO,** *Chief Economist for Emerging Markets, BBVA; Visiting professor, the University of Hong Kong*
- **Domenico LOMBARDI,** *President of The Oxford Institute for Economic Policy; former member of the Executive Boards of the IMF and the World Bank; Senior Fellow, the Brookings Institution;*
- **Luca SILIPO,** *Chief Economist for Asia Pacific, NATIXIS.*
- **Andrew WALTER**, *London School of Economics and Political Science; Academic Director of the TRIUM Global EMBA (by LSE, NYU Stern, and HEC Paris)*
- **Khan H. ZAHID,** *Former Chief Economist & Vice President, Riyad Bank*

Production
- Rebecca CHEN, Paul CONROY, Nikolai TAGAROV, CHEN Yue, WANG Xin, WANG Zhenhuan, XU Hui, YANG Yongchen, ZHOU Caixia



Direction for Interest Rate Liberalization in China

Contents

Abstract: *The main goal of interest rate liberalization is to establish a mechanism whereby deposit and loan interest rates in financial institutions are determined by market supply and demand, to regulate and guide market interest rates through the use of monetary policies, and to make the market play a leading role in allocating financial resources. At present China is accelerating the process of interest rate liberalization, which will be discussed in this paper.*

I. The Interest Rate Liberalization Process in China

Before interest rates were adjusted twice in 2012, liberalization of deposit and loan rates in China has been mainly concerned with the following three issues.

The first issue is RMB loans. After the outbreak of the financial crisis in 1997, when there was little difference among loan interest rates, small and medium-sized enterprises were not competitive with large enterprises, and they found it more difficult to obtain loans. In order to support small enterprises in obtaining loans, the upper limit for the lending rate for small enterprises was increased to 20% on October 31, 1998, while the upper limit for large and medium-sized enterprises remained at 10%. In 1999, the upper limit for loans to small and medium-sized enterprises from financial institutions and commercial banks at the county level and lower was increased to 30%. In 2003, the loan interest rate cap for rural credit cooperatives was increased to two times the benchmark interest rate. In January 2004, the loan interest rate cap for urban credit cooperatives and commercial banks was increased to 1.7 times the benchmark interest rate and the loan interest rate floating cap did not change for different types of enterprises. In October 2004, the lending interest rate cap was limited to 2.3 times the benchmark interest rate for urban and rural credit cooperatives and the cap limit for other financial institutions was removed; thus the limit for the RMB lending interest rate cap was eliminated and the limit for the rate floor was regulated. In addition, the lowest interest rate for housing mortgage loans was decreased in 2006 and again in 2008, mainly to promote housing consumption, to help resist the recent economic crisis, and to further promote the liberalization of retail banking loans.

The second issue is RMB deposits. The reform process for deposit interest rate liberalization, which is far slower than for loans, was initially attempted in the interagency wholesale market. In October 1999, the deposit interest rates for large scale savings from insurance companies were determined by negotiation with commercial banks; from 2002 to 2003, the scope of the negotiated deposit interest rate gradually expanded, and in October 2004, cap limit management was introduced. Since then, the policy of restricting the cap limit while allowing the lower limit to float downward has been maintained for the deposit interest rate.

The third issue is foreign currency deposits and loans. As the domestic proportion of foreign currency deposits and loans is not high and the market is becoming more mature, interest rate liberalization is progressing rapidly. In 2000, the domestic interest rates for foreign currency loans and the interest rates for large scale foreign currency deposits over $3 million U.S. were completely liberalized; in July 2003, the number of regulated foreign currencies with regulated small scale deposit interest rates decreased to four from the original seven; in November 2003, the lower limit for interest rates for small scale foreign currency deposits was liberalized; in November 2004, interest rate regulations for small scale foreign currency term deposits of one-year and over were fully removed.

II. The Current Situation in Interest Rate Liberalization

First, interest rate adjustment policies announced in 2012 by the central bank on June 7 and July 6, readjusted deposit and loan interest rates as well as their floating range, which set a significant milestone in the process of interest rate liberalization. The current lower range for the one-year lending interest rate and the upper range for deposit interest rates from financial institutions was increased to 0.7 times and 1.1 times the benchmark interest rate respectively. After two adjustments, the liberalization of deposit interest rates has made great progress. Breaking the deposit rate cap means that this reform has entered a unique period; furthermore, the lending interest rate for financial institutions, except urban and rural credit cooperatives, has had the upper limit removed and they have the right to independently set the interest rate up to 30% below the benchmark rate. In practice, the interest rate is determined by negotiation between banks and customers according to financial cost, risk status, and profit targets, which basically reflects a situation of supply and demand in the capital market.

Second, with the establishment of a national unified inter-bank lending market in 1996, China's interest rate liberalization process has lasted for more than 10 years. The interest rate liberalization of the bond market, monetary market, and the foreign currency deposit and loan market has basically been completed, and the next step is to promote the process for RMB deposits and loans. At present, commercial banks have greater pricing power over RMB interest rates: the upper limit for loan interest rates and the lower limit for deposit interest rates have been opened, active management of the floating range has been adopted, and the floating range has been further increased.

Therefore, as stated, interest rate liberalization in China has already entered a unique period, and the next steps should be gradually promoted.

III. Impacts of Interest Rate Liberalization

First, there are still many barriers against interest rate liberalization. Overall, the reforms can not and should not progress too fast because of motivation, institutional constraints, and associated risks. Moreover, interest rate liberalization, according to the reform procedure, cannot proceed alone as it is closely related to administrative systems. In particular, before carrying out substantial reforms of the deposit interest rate, many basic systems, including the deposit insurance system, need to be improved. Objectively speaking, China is not equipped for the prompt implementation of interest rate liberalization considering the banking structure, bond market structure, and the monetary policy model.

In addition, the lack of financial innovation restricts the process of deposit interest rate liberalization. When new financial products are created to replace the existing deposits and loans, the double controls of the market and management will transition to the single control of the market. For example, the main tools for deposit interest rate liberalization in the United States include large scale negotiable certificates of deposit (CDs), negotiable order of withdrawal accounts (NOW accounts), Super NOW accounts, money market deposit accounts, etc.

Second, the commercial banks will be impacted most by interest rate liberalization. If deposit and loan interest rates are entirely open, commercial banks must compete for limited resources, especially deposit resources, thus price competition is inevitable. From foreign experience it can be seen that the deposit interest rate is certain to rise in the initial stage, which means that the spreads between deposits and loans will decrease sharply for commercial banks. The profit model for the commercial banks shows that the assets and liabilities structure is relatively uniform, and interest is still the main income source. Therefore, a sharp decrease in interest income is likely to negatively impact profits which may affect the development of the banking industry.

IV. Direction for Interest Rate Liberalization

Implementing interest rate liberalization is not only a general trend in global financial development but also a goal of financial reform in China.

Mismanagement of interest rate regulations is only exposed gradually in the current domestic and international economic and financial environment, an issue which has become a driving force for accelerating the liberalization process. Strict and long-term interest rate regulation has made commercial banks develop a profit model which relies primarily on growth and spreads; domestic credit sources are in short supply while private credit is in greater demand during this period of economic austerity. Interest rate liberalization is also required for the internationalization of the RMB and for accelerating capital account liberalization.

Conditions are adequate for accelerating the interest rate liberalization process in China. In recent years, the emergence of various financial and trust products indicates that there is a demand for price adjustments; the increased size of the capital market and the gradual improvements in the bond market indicate that the field of financial assets, where prices are determined by the market, is expanding; financial institutions have established a market-oriented pricing structure, the market-oriented deposit and loan pricing procedures are continuously being improved in the banking industry, and the micro-foundation is becoming firm; the interest rate regulation system of the central bank is progressing and its ability to guide interest rates by using monetary policies is increasing.

Therefore, interest rate liberalization is not only required for developing the financial market in China, but it is also an inevitable choice for financial institutions and regulatory authorities confronted by interest rate regulation mismanagement.

CHINA's ECONOMY & POLICY

Service & Price

www.china-economy-policy.com

Publications of China's Economy & Policy	1-10 users (US$)	11-40 users (US$)
Single report	100	200
Single issue (10 -12 reports)	800	1,600
Annual subscription (12 issues/monthly)	4,800	9,600
Annual subscription (12 issues/ monthly) + Advisory*	9,600	19,200
Annual subscription (6 issues/bi-monthly)	2,400	4,800
Annual subscription (4 issues/quarterly)	1,600	3,200

*ADVISORY services include brief answers to questions and requests for clarification, opinions, suggestions, and consultations by our economists or editors. Advisory services are limited to discussing or clarifying four issues per client each month.

NOTE: We offer a great discount for non-profit and academic institutions, please contact us for details.

Tailored Research & Consulting	Start from (US$)
Tailored Report (similar format to CEP publications)	3,500
Research Project	10,000
Research + seminar with economists	25,000
Research + seminar with economists & policy makers	50,000

Conference Calls & Interviews	Start from (hourly rates/US$)
Conference call with an economist	1,000
Face-to-face interview with an economist	2,000
Conference call with a policy maker	1,000
Face-to-face interview with a policy maker	2,000

PAYMENT: We accept payment by bank transfer only. Our bank account details will be provided once you email us the order to cep@thegateway-group.com

MONEY BACK GARANTEE: If a client is not satisfied with the subscription during the first two months of subscription, we will refund the unexpired portion.

Industry & Topics

Industry Coverage

Financial service	New energy automobile	Electrical power	Healthcare
Renewable energy	High tech	Iron and steel	Metal and mining
Strategic emerging industries	Real estate	Equipment manufacturing	Public sector
Low carbon economy	Energy (oil,coal,natural gas)	Railway	Social sector

Topic & Project Focus

Macro economy	Fiscal policy and taxation reform	Financial supervision reform	Regional development
Monetary policy	Private capital and investment	International/overseas investment	Rural economy
Foreign reserves	Going global strategy	Financial and banking risk	Income distribution and social welfare
RMB exchange rate and internationalization	Hot money	Capital markets	

CHINA's ECONOMY & POLICY

Insiders' insights

www.china-economy-policy.com
CEP@thegateway-group.com

Published by
Gateway International
www.thegateway-group.com

Shanghai Office
16F Feidiao Building, 1065 Zhaojiabang Road,
Shanghai, 200300, China

Beijing Office
Room 212, No.1 Building, 5 Jianguomennei Street,
Beijing, 100732, China

Hong Kong Office
C1-Room 1708 Nan Fung Tower, 173 Des Voeux
Road C., Hong Kong

Toronto Office
Suite 403, 133 Richmond Street West,
Toronto, Ontario, M5H 2L3, Canada

Gateway International *is a consulting firm which operates in two major fields by providing top-quality research and consulting as well as professional financial services, relying on the solid economic and policy research capabilities of our staff. We support our clients, both in China and overseas, by enabling them to not only follow the fast-changing Chinese business trends but also to thoroughly understand how to adapt to the country's dynamic market environments. For more information please visit www.thegateway-group.com or write to cep@thegateway-group.com*

published by
Gateway International