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Mizuho Economic Outlook & Analysis

August 22, 2019

China's interest rate marketization takes a step forward

Interest rates cut substantively, albeit marginally, following reform measure

< Summary >

◆ In China, the reform of marketizing lending and deposit interest rates has yet to be completed, and this has led to distortions in the financial system, including the declining effectiveness of monetary policy. On August 17, however, the People's Bank of China announced a measure to advance the interest rate reform.

◆ The measure is to review the loan prime rate (LPR), the benchmark rate introduced in 2013, and use this as the reference benchmark for lending rates. While the lending base rate is to be abolished, the deposit base rate is expected to be preserved out of consideration for earnings of financial institutions.

◆ Following the review of the LPR, the virtual "interest rate reduction," however marginal, actually took place. Going forward, a reduction in the policy rate is on the horizon. On the other hand, the rate reform is only a half-way through, probably requiring a long-term approach toward the full interest rate marketization.

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1. New development in the interest rate marketization reform

Following the progress in the market-oriented economic reform since the reform and opening-up in 1978, China has proceeded with the interest rate marketization reform in incremental steps. As a result, interest rates in the money and capital markets have been marketized. On the other hand, the marketization of bank lending and deposit interest rates is still halfway through. This is because, while that marketization is an important matter for the Chinese government that influences monetary policy and financial system reform, it will substantially affect a broad range of economic entities.

Regarding the remaining reform of marketization of bank lending and deposit rates, the measure for advancing that reform was announced on August 17, 2019. The regulatory authorities have been increasingly transmitting messages on the reform since April 2018, which had been less frequent in recent years, and after a period of about a year and half of consideration, they finally announced the official policy.

In this paper, we will first look at the current interest rate structure and its problems, then explain a broad outline of the review of the most advantageous interest rate called the "Loan Prime Rate (LPR)," the thrust of the latest reform measure, and finally consider a potential impact on monetary policy and the future outlook of the interest rate marketization.

2. China's interest rate structure and its problems

(1) Coexistence of marketized rates and not-fully-marketized rates

We can broadly divide the interest structure in the Chinese financial markets into policy rates and market rates, which are shown in **Chart 1** on the following page. The former includes interest rates of traditional monetary policy instruments, such as lending and deposit base rates, reserve requirements, and market operations (repurchase and reverse repurchase operations) as well as interest rates of relatively new monetary policy instruments created since 2013 in incremental steps, such as short-term liquidity operation (SLO), standing lending facility (SLF), medium-term lending facility (MLF) and pledged supplementary lending (PSL). Levels of these interest rates are set individually.

The latter interest rates can be broadly divided into money market rates, capital market rates, bank lending and deposit rates, and shadow banking rates. As stated at the outset, money market and capital market interest rates have already been marketized, and they basically fluctuate in accordance with supply and demand of funds. As for interest rates on financial assets comprising shadow banking, they are being priced under the market mechanism based on the rates of return for assets under management. On the other hand, as shown below, bank lending and deposit rates have yet to be fully marketized.

Chart 1: The interest rate structure in China

Type		Principal rates	Term
Policy rates	Base rates	Lending/deposit base rates	Lendings (less than 1 year, 1 to 5 years, over 5 years) Deposits (demand deposits, time deposits (3 months to 3 years)
	Reserve requirements	Reserve requirement ratio, interest on excess reserves	–
	Monetary policy instruments	Repurchase and reverse repurchase operations	7 to 182 days
		Short-term Liquidity Operation (SLO)	Up to 7 days
		Standing Lending Facility (SLF)	1 day to 1 month
		Medium-term Lending Facility (MLF)	3 months to 1 year
		Pledged Supplementary Lending (PSL)	3 to 5 years
		Re-lending, rediscounting	Up to 1 year
		PBOC bills	3 months to 3 years
Market rates	Money market	Interbank repurchase operations (between deposit-taking financial institutions (DR), between all financial institutions (R))	Overnight to 1 year
		Shanghai interbank offered rate (SHIBOR)	Overnight to 1 year
		Certificates of deposit (CDs)	Interbank (1 month to 1 year) individuals, corporations (1 month to 5 years)
	Capital market	Government bonds (sovereign bonds, local government bonds)	Sovereign bonds (up to 50 years), municipal bonds (up to 30 years)
		Bank debentures (policy financial institutions, commercial banks)	Policy (up to 50 years), commercia l (up to 20 years)
		Corporate bonds (CP, MTN, corporate bonds, public corporation bonds, etc.)	CP (up to 1 year), MTN (up to 5 years). Corporate and public corporation bonds (up to 15 years)
	Bank lendings/deposits	Lendings, deposits	Short-term to medium- and long-term
		Loan Prime Rate (LPR)	One year (previously) → One year, 5 years (post-reform)
	Shadow banking	Wealth management products, non-standardized claims	Short-term to medium- and long-term

Source: Made by MHRI based on People's Bank of China, various materials

(2) The marketization reform of lending and deposit rates only halfway through

Regarding bank lending and deposit rates, while the base rates described above and margins of deviation from the base rates (the floor for lending, the ceiling for deposits) had been set for a long period of time. But system improvements have been gradually undertaken toward their marketization. For example, the regulations for setting the floor for lending rates and the ceiling for deposit rates were abolished in July 2013 and October 2015, respectively. As for the base interest rates, as the benchmark to replace them in the future, China began announcing and administering the LPR calculated on the basis of most preferential interest rates quoted by 10 major banks in October 2013.

Although the marketization of interest rates has been gradually progressing, centering on lending rates, through these institutional reforms, the decisive change has yet to come.

While short-term interest rates are increasingly influencing lending rates after the abolition of the floor rate, the People's Bank of China still regards the base rates as policy rates, with the major role of lending base rates as the benchmark kept intact. The same can be said also about deposit rates.

The role of the LPR is limited as well. While some quoting banks calculate their LPR by also referencing short-term rates, most quoting banks, mainly state-owned major commercial banks, use the deposit base rate as the core benchmark in calculating their LPR. Banks still reference the lending base rate instead of the LPR in setting their lending interest rates. Consequently, the levels and changes of the LPR actually continued to mirror those of the lending base rate (**Chart 2**).

Furthermore, there remain substantive restraints on the range of rate changes. Regarding lending rates, the People's Bank of China reported that individual banks engaged in the practice of setting the floor for lending rates (for example, "the base rate × 0.90 times") after consultations among banks. Deposit rates are also substantively regulated under the market interest rate pricing autonomous mechanism set up in September 2013 as well as under the Macro Prudential Assessment (MPA) system introduced on a full-fledged basis in 2017 as the framework for supervision and management of financial institutions.

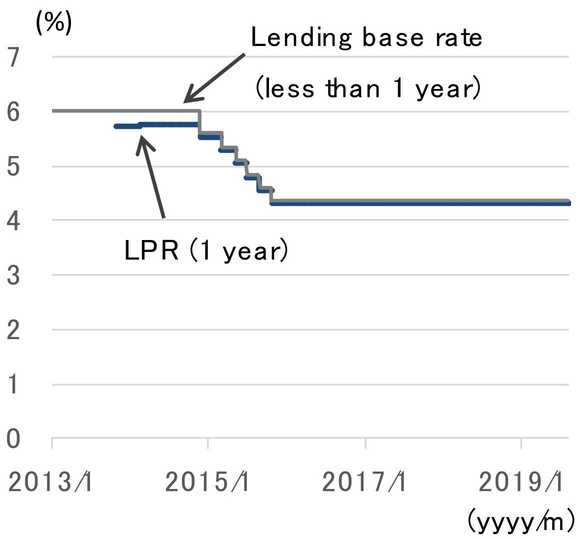
(3) Distortions of the financial system due to the incomplete interest rate marketization

As seen above, the situation where marketized rates and incompletely marketized rates coexist among market interest rates has generated distortions in the Chinese financial system. The following three points can be pointed out as major problems: (1) commercial banks direct their loans toward state-owned companies; (2) the difficulty in supervising and managing money flows due to outflows of deposits and their shift toward other financial assets; and (3) the inadequate functioning of the transmission mechanism of monetary policy using interest rates.

(1) represents the structural problem that has long stayed with the financial system in China. As lending and deposit rate levels are determined uniformly by the government, commercial banks, guaranteed to have certain margins, have few incentives to pursue returns commensurate with risks, resulting in the tendency to no small extent of their loans being directed toward central and regional state-owned corporations offering greater safety. As a result, private companies with higher risks than state-owned corporations have been put at a disadvantage in raising funds from banks.

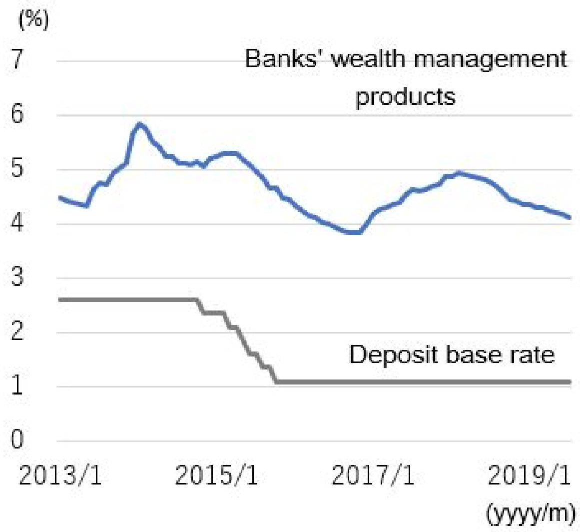
The difficulty mentioned in (2) became conspicuous with the remarkable growth of shadow banking, as represented by wealth management products, since early in the 2010s. The deposit base rate was set at relatively low levels to supply low-cost funds necessary for the development of the real economy ("financial repression"). In contrast, there was no ceiling set on interest rates on wealth management products virtually seen as risk-free assets as deposits, and they were priced higher than deposits (**Chart 3**), leading to the outflows of bank deposits. Shadow banking played the role of supplementing bank lending as fund-raising channels for private companies, etc. It also served as fund-procuring channels for real estate development and other sectors subject to lending restrictions, thereby eroding the effectiveness of lending curbs through window guidance, etc.

Chart 2 Lending base rate and LPR



Note: The LPR shows the rates released up to August 16, 2019, under the conventional method.
Source: Made by MHRI based on People's Bank of China, CEIC Data

Chart 3 Deposit rates and return on wealth management products



Note: 1. All three-month rates
2. Actual deposit rates stand at the lower half of the 1% range as they are placed under the virtual ceiling, resulting in disadvantageous interest rate differentials with wealth management products.
Source: Made by MHRI based on People's Bank of China, Wind

The transmission mechanism of monetary policy mentioned in (3) is gaining in importance as the People's Bank of China is shifting its monetary policy to follow the steps of monetary policy of advanced economies, which focuses on the pricing (interest rates) rather than on the quantity of money. In particular, the necessity of the improved mechanism appears to have been recognized more strongly as the credit easing by the People's Bank of China failed to lead to the lowering of fund-raising costs in the economic slowdown phase since 2018. For instance, as PBOC Governor Yi Gang cited as an example, though the interbank repo rate for seven days, one of the representative short-term interest rates, declined, albeit with some swings, and the one-year government bond yield also fell, bank lending rates have shown no noticeable declines as the base rate, which should have a major impact on bank lending rates, has been kept unchanged (**Chart 4**).

3. The present direction of the interest rate marketization reform

(1) Lending base rate switched to LPR, but deposit base rate preserved for the time being

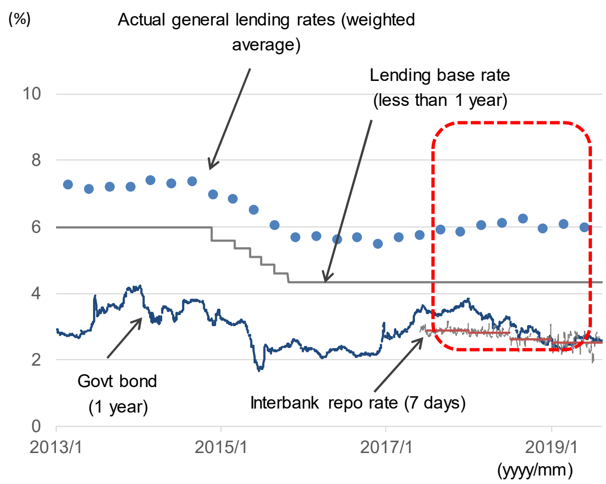
What the People's Bank of China unveiled recently is the measure related to the review of the LPR created as the benchmark alternative to the lending base rate.

The ultimate goal of the interest rate marketization is the building of the mechanism to determine lending and deposit rates based on marketized short-term interest rates. But conditions necessary for the complete marketization are not yet in place. Short-term interest rates regarded as the future policy rates (target rates of the People's Bank of China), such as the interbank repo rate and SHIBOR, and government bond yield curves, which serve as the base for the transmission of short-term rates to long-term rates are not sufficiently stable yet. If the lending and deposit base rates are abolished in a single step under these circumstances, lending and deposit rates will likely become unstable to have adverse impacts on the economy and financial markets. Thus, the People's Bank of China is thought to have adopted a policy to make use of the improved LPR as a measure to avert radical changes.

Following the latest measure, the lending base rate is likely to be abolished going forward. In May 2019, PBOC Governor Yi Gang stated that "While actual regulations on lending rates have already been abolished, we can move ahead to further study the reform scheme, including the cessation of announcements of the lending base rate."

On the other hand, regarding deposit rates, PBOC Governor Yi Gang, in addition to the aforementioned remarks, said that "In the process to further promote the interest rate marketization reform, the deposit base rate will continue to play an important role," suggesting that the reform of deposit rates would be postponed. This apparently reflects the central bank's consideration for a potential adverse impact on earnings of financial institutions stemming from higher fund-procurement costs as well as the underdeveloped state of systems necessary for the marketization (details are described later).

Chart 4 Risk-free interest rate and lending interest rate



Note: The interbank repo rate covers transactions between deposit-taking financial institutions. The straight line indicates the average rate for every six months.

Source: Made by MHRI based on People's Bank of China, CEIC Data

(2) Calculation of LPR changed to the method primarily referencing MLF rate of PBOC

In order to make the LPR a better benchmark to refer to, the latest measure by the People's Bank of China reviewed the reference interest rate benchmarks, the number of quoting banks, the method of calculation, the frequency of rate announcements, and the term of interest rates (**Chart 5**).

Of these matters, the most important point in enhancing the effectiveness of the LPR for marketizing lending rates is the reference interest rate benchmarks. Regarding the review of the LPR, before the announcement of the latest measure, intellectuals in China pointed to a variety of possibilities by referencing the case examples of Japan and other foreign countries. More specifically, the floated ideas included (1) the calculation method based on banks' debt costs and operating costs, etc.; (2) the method to reference policy rates (market operation rates, SLF and MLF rates, etc.); and (3) the method to reference short-term rates (interbank repo rate, SHIBOR and CD rates, etc.). In the actual measure announced, the LPR is to be set by referencing the one-year MLF rate and by considering such additional factors as the fund-raising costs (including short-term rates, etc.) of quoting banks, fund supply and demand, and risk premiums, etc. In light of the above-mentioned ideas, the latest measure can be termed as a combination of principally (2) and (3) as a subordinate idea.

From the perspective of the genuine marketization, (3) appears to be desirable. However, looking at the combination of the MLF rate, which excels in the stability as a policy rate of the People's Bank of China, and short-term rates that reflect market fund supply and demand but lack sufficient stability, it suggests that the Chinese government, for the improvement in the LPR mechanism, is trying hard to achieve both the strengthening of the role of the market mechanism and the ensuring of the economic stability. The change in the frequency of rate announcements from every business day to only on the 20th of each month seems designed to flatten the potential impacts of daily fluctuations of short-term interest rates. When China carried out the marketization reform of the exchange rate determination mechanism, it initially adopted the method to principally reference the market supply and demand in the form of the previous day's closing. In response to subsequent unstable movements of the renminbi (the Chinese yuan), however, China added market-stabilizing elements, such as the currency basket and countercyclical factors. Its reflection on this incident appears to be reflected in the latest review of the LPR for the interest rate marketization.

Other areas of the review appears to reflect China's intentions to enhance the representativeness and referenceability of the LPR. For example, the number of quoting banks was increased from 10 nationally active banks to a total of 18 banks, including banks active in regions as well as foreign and private banks. The method of calculating the LPR was also changed from the previous weight average value based on outstanding loans of quoting banks to the arithmetic mean value. These changes are expected to reduce the bias due to the geographical scope of business operations or lending balances of quoting banks and reflect the actual lending conditions of banks with varied backgrounds. In addition, the terms covered was expanded by adding five years to the previous term of only one year to make the LPR easier to use as the reference interest rate in making medium- and long-term loans.

The lending rate referencing the new LPR is applicable to loans to be newly issued going forward. On the other hand, the current contracted interest rates continue to apply to existing loans outstanding.

Chart 5 Overview of the review of the LPR

	Previous	New (on and after August 20, 2019)
Reference interest rate benchmark	No clear provisions (In actuality, many quoting banks referenced the base rates)	Interest rates used in open market operations (Mainly 1-year medium-term lending facility (MLF) rate)
No. of quoting banks	10 banks ※Originally, 9 banks, but one more bank was added in 2017. (5 state-owned banks, 5 joint-stock commercial banks)	18 banks ※ To be reviewed periodically (5 major state-owned banks, 5 joint-stock commercial banks, 2 urban commercial banks, 2 rural commercial banks, 2 foreign invested banks, 2 private banks)
Calculation method	Calculated by the weighted average using the weights of outstanding loans of quoting banks following the exclusion of the highest and lowest quotes.	Calculated by the arithmetic mean value following the exclusion of the highest and lowest quotes.
Frequency of announcements	Every business day	20th of each month (if the day falls on holidays or non-work days, the next business day)
Term	One year	1 year, 5 years
Other	–	The People's Bank of China strictly deal with breaches of the rule, such as the practice of banks colluding to set the hidden floor rate. The status of referencing the LPR and the status of competition in lending rates are assessed periodically under the Macro Prudential Assessment (MPA) system.

Source: Made by MHRI based on People's Bank of China

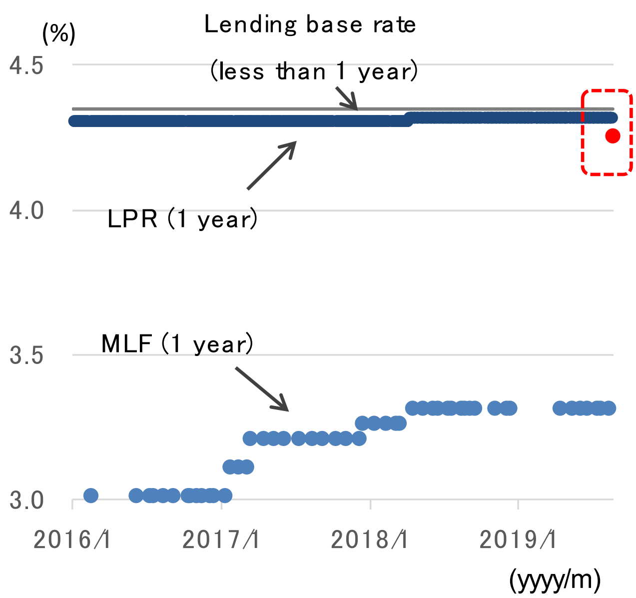
4. Shift to the new LPR mechanism results in virtual "rate cut," albeit marginal

After the launch of the operation of the new LPR mechanism, the LPR (one year) released on August 20 came to 4.25% (**Chart 6**). Compared with the current lending base rate of 4.35%, the latest LPR represented a virtual "rate cut" albeit by a small 10 basis points. Going forward, based on the new LPR mechanism, the MLF rate, now standing at 3.3%, may be lowered and the People's Bank of China, in the conduct of its monetary policy, may guide short-term rates lower. As reasons for such expectations, mainly the following two points can be cited: the rising need for additional credit easing and the lowering of hurdles to implement interest rate reductions.

Regarding the former, downward pressure on the Chinese economy, mainly from exports, may strengthen further in view of the scheduled imposition of the fourth round of US retaliatory tariffs on imports from China on September 1. Ideally, instead of lowering risk-free interest rates through reductions in policy rates, the People's Bank of China would rather intend to guide lending rates lower by encouraging a compression of add-on interest rates that reflect risk premiums, etc. through the promotion of competition among banks via the marketization. But the realization of lower rates through this route would require some time. From the perspective of attaining quick effects, it is highly likely that the People's Bank of China will consider a move to lower the MLF rate, the main reference interest rate for the LPR, in addition to the cut in the reserve deposit ratio and the tolerance of the depreciation of the renminbi.

Regarding the latter, in China, a cut in the base rates had been considered as a policy rate cut. Such rate cut would directly change the lending rates with a bigger impact on the real economy and would send a strong message to the financial markets. As such, the People's Bank of China has not resorted to a change in the base rates since November 2015. However, if the latest measure realizes the shift of the focus from the base rates to the LPR, the rate cut would have only an indirect impact on lending rates, effectively lowering the hurdle to carrying out the policy rate reduction. Furthermore, major industrial countries and regions are expected to ease credit further following the US Federal Reserve's reduction in the federal funds rate in July. The domestic environment should also make it easier for the People's Bank of China to go for additional monetary easing given that the domestic inflation rate stays within the government's target range.

Chart 6 MLF Rate and LPR



Source: Made by MHRI based on People's Bank of China, CEIC Data

5. Numerous problems still remain to be cleared for the complete marketization

As seen above, developments related to the marketization of lending and deposit rates that became re-accelerated in 2018 are expected to quiet down with the review of the LPR and the switchover to the transitional mechanism where the lending base rate is replaced by the new-look LPR. Even after the review, the LPR is calculated by mainly referencing the MLF rate, one of the policy rates, which is expected to contribute to averting any erratic fluctuations of lending rates. Thus, the latest measure can be appreciated as the steady move to proceed with the reform in a stable manner.

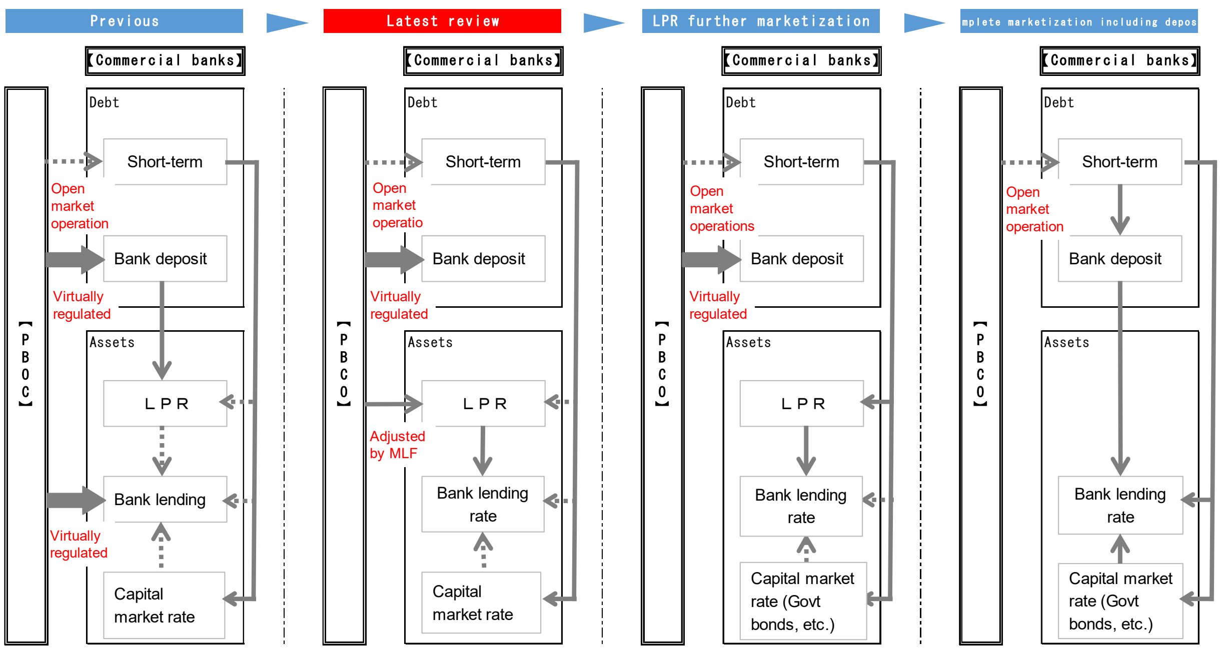
From the perspective of the complete marketization, however, the latest reform represents just a milestone (**Chart 7**). It is necessary for China to continue to tackle a variety of problems going ahead in order to realize the further marketization of lending rates and then to undertake the marketization of deposit rates.

The principal issues that should be addressed include (1) enhancement of the stability of short-term rates and bond yields (government bonds in particular); (2) enhancement of financial institutions' interest rate pricing abilities; (3) improvement of the legal system to handle the resolution of failed financial institutions; and (4) elimination of "soft" budget restraints of state-owned enterprises.

The enhanced stability of short-term rates cited in (1) will become the required condition regardless of whether China makes short-term rates into the key reference interest rates for the LPR in place of the MLF rate or whether China ultimately make a shift to the mechanism of determining lending and deposit rates based on short-term rates by weakening the role of the LPR itself. Through the efforts such as the further sophistication of the interest rate corridor now under development, improved communication by the People's Bank of China, and the development of the government bond market, the Chinese authorities is being called upon to enhance the stability of short-term rates and bond yields and determine the policy rate to be set as the target rate in the future.

Regarding (2), it will be necessary that commercial banks become able to price adequate interest rate levels on their own without relying on the base rates. At present, as the single benchmark exists in the form of the base rates, they can do such pricing by the relatively simple method of adding a fraction to or deducting a fraction from the base rates. Once the complete interest rate marketization is realized, however, they need to do pricing by taking multiple elements into account, including various funding rates, or costs, like short-term rates and deposit rates, risk premiums in accordance with the macro environment and customer attributes, etc., lending terms, and other elements. Thus, financial institutions, particularly small ones, will be required to improve

Chart 7 Current status of interest rate marketization and the future direction



Source: Made by MHRI by referencing “”利率并轨”的务实选择” (“FTChinese com.”, May 30, 2019) their pricing capacities by investing reasonable amounts of time and money in systems, human resources and organizational structures.

As for (3), there is the possibility that inferior financial institutions may fail amid intensified competition among financial institutions associated with the progress in the interest rate marketization. In preparation for such development, it is necessary to put in place the legal system for failure resolution. In China, the deposit insurance system was initiated in 2015, but the system is not yet functioning satisfactorily. China only recently started studying the legal system to address possible failures of financial institutions, with no such system yet on the horizon. Thus, in the recent cases of management problems at financial institutions, the Chinese authorities dealt with them on a case-by-case basis, either the government condemning them or having major banks make investment to rescue them. Given the possible increase in the number failing financial institutions, it is necessary to establish the dedicated legal system to systematically deal with the resolution of failed financial institutions.

Regarding (4), it is imperative to eliminate the problem of "soft" budget constraints on central state-owned companies and regional state-owned companies as represented by local government financing platforms against the backdrop of tacit government guarantees. Even when interest rates are marketized, there exist concerns that the existence of tacit government guarantees would distort interest rate pricing and would not improve the situation where private companies are forced to put up with disadvantageous interest rates relative to state-owned companies. Therefore, it is necessary to impose "hard" budget constraints on state-owned companies through efforts to dispose of so-called hidden liabilities of local governments, such as debts of local government financing platforms, in a manner not holding local governments responsible for debt repayments.

It is not so hard to imagine that all the challenges cited above are unlikely to produce good results in a short space of time. The Chinese government headed by President Xi Jinping has been pushing ahead with the interest rate marketization reform by setting 2020 as the target year. But China is still a long way from having the mature financial system. China is expected to continue with the interest rate marketization reform in 2021 and beyond as a very long-term project.