A study about problems of Interest Rate Liberalization Reform in China

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Abstract: China's interest rate liberalization is conducive to promoting the fundamental transformation of the operation mechanism of state-owned banks and carrying out commercial and enterprise management. At the same time, the integration of interest rates has improved the micro transmission mechanism of monetary policies, enabling financial institutions to control certain floating rights of deposit interest rates, reduce their dependence on national benchmark interest rates, and have the ability to set their own prices. Moreover, further promoting the marketization of deposit and loan interest rates and improving the assets and liabilities capacity of commercial banks can also bring higher stability to China's financial market. In addition, encouraging the innovation of financial products can provide higher flexibility to the interest rate market and promote the process of interest rate liberalization in China.

1. Introduction

Since China's reform and opening up, the interest rate market has undergone major changes. In 1993, the Third Plenary Session of the 14th Central Committee of the Communist Party of China "Decision on Several Issues Concerning the Establishment of a Socialist Market Economic System" put forward the basic idea of interest rate marketization reform. And in 2003, the Third Plenary Session of the Sixteenth Central Committee of the Communist Party of China used the "Decision on Several Issues Concerning the Perfection of the Socialist Market Economic System" to roughly describe the interest rate market reform. These policies have made China's interest rate market initially perfect, but there are still many problems in it. For example, there is a dual-track problem of the coexistence of benchmark deposit and loan interest rates and market interest rates, and due to poor interest rate transmission, it hinders the effect of the policy. In addition, deposit interest rates have experienced upward pressure after the liberalization of deposit and loan interest rates. Finally, the insufficient development of the national debt market and the bill market is also a major problem in the interest rate market. First of all, this article will first discuss the reasons for these problems, and then discuss suggestions for the reform of China's interest rate market from the perspectives of loan interest rate unification, improvement of LPR formation mechanism, national interest rate system, currency control tools and financial product innovation [4].

2. Current situation of China's interest rate liberalization reform

As the Central bank liberalized the inter-bank lending rate in 1996, China's interest rate liberalization reform began and has been continuously advancing. On June 8, 2012, the People's Bank
of China further relaxed the floating range of the general RMB deposit interest rate of financial institutions and raised the deposit ceiling to 1.1 times of the benchmark interest rate. Loan threshold is adjusted for 0.7 times the benchmark interest rate, in the first half of 2021, the People's Bank of China to continue market-oriented interest rate reform, to further strengthen and perfect the system of the central bank policy interest rate, improve the marketization of interest rate and the transmission mechanism, the developments since throughout the implementation of normal Chinese currency and interest rate policy, in the first half of this year, In June, the weighted average interest rate of loans was 4.93%, a new low since statistics began. The weighted average interest rate of corporate loans was 4.58%, 0.06 percentage points lower than the same period of last year. The comprehensive financing cost of small and micro enterprises was on a steady decline. But because of the global epidemic situation is still quite serious, other countries' economic situation is complicated, China's economic development and the recovery is still not stable, weak, China also signaled, the next stage of the reform, will continue to perfect the system of the central bank policy interest rate, continuously optimize the deposit rate regulation, real interest rates down further.

2.1 China's policy on interest rates in 2021

1) Since 2021, China has continued to promote financial institutions to improve the use of LPR pricing mechanism, continuously send signals of LPR reform, optimize the regulation of deposit interest rate, and maintain the basic stability of bank debt cost. On June 21, 2021, the self-regulation mechanism of market interest rate pricing further optimized the determination method of self-regulation ceiling of deposit interest rate. Further safeguarding banks' independent power to set interest rates has also made the whole market more orderly.

2) In the first two quarters of 2021, the loan-weighted average interest rate is 5.07%, 0.07 percentage points lower than the same period of last year, and 0.08 percentage points lower than the whole year of last year. Among them, the enterprise loan interest rate has the biggest decline, the weighted average interest rate of enterprise loan in the first six months is 4.63%. It was 0.16 percentage points lower than the same period in the first half of the year, and 0.09 percentage points lower than the whole year.

3) Money market rates remain stable, but the market trade growth began to slow, in June, the pledged repo on the weighted average interest rate of 2.17%, compared to march over the same period level up to 16 basis points, banking deposit financial institutions pledged repo rates between debt on the weighted average interest rate of 2.04%, below the weighted average interest rate on mortgage repo month 13 basis points.

4) In the first half of 2021, the transaction volume of RMB interest rate swap market was 142,000, with a year-on-year decrease of 1.9%, and the nominal principal amount was 11.1 trillion yuan, with a year-on-year increase of about 12.7%. Since the first half of this year, the transaction volume of LPR-based interest rate swap was 419, with a nominal principal of 43.29 billion yuan. This also means that China's LPR interest rate development is stable. (China's banking market officially launched interest rate option business linked to LPR in March 2020, and added interest rate option varieties linked to bank repo fixing rate (FDR) on March 29, 2021)

2.2 The impact of LPR reform on commercial banks and financial markets

After the LPR reform, bank interest margins began to narrow, which also means that the pressure on bank profitability has increased. For commercial banks, they should further reduce banks by optimizing the liability structure, restricting the scale of large deposits and loans, and adjusting deposit rates. The second is the differentiated pricing strategy, which achieves maximum profitability by further refined cost management and differentiated pricing for each customer. The third is the use of financial technology to further accurately position prices and strengthen risk control. Monetary policy is guiding banks to connect LPR to the bank’s internal fund transfer pricing (FTP). At present, due to the further implementation of reforms, large commercial banks have completed the docking, but for small commercial banks, due to their own, the profit point is to attract more customers to achieve profitability by lowering the interest rate of large commercial banks. However, the implementation of the LPR reform has further compressed the profitability of the banking industry, which has also caused
large commercial banks to begin to pay attention to all levels. Customers also formulate more detailed strategies, which will further narrow the difference in interest rates between small banks and large banks. This is likely to cause small banks to go bankrupt because they are unable to make profits. Because interest rate cuts narrow the interest rate differential, large banks lack the motivation to initiate loans. The loan requirements are further increased to ensure the generation of non-performing assets. Small banks obtain profit by attracting their risky customers to carry out loans and other activities. However, this is likely to further aggravate the accumulation of non-performing assets of banks, and because the central bank cannot completely independently According to independent monetary policy decisions, and the long decision-making time makes it impossible to keep up with changes in economic trends. The strict interest rate mechanism prevents banks from floating interest rates autonomously. This will result in the inability of healthy competition in the field of financial institutions and the emergence of several major banks. To control the interest rate of the entire financial market, and due to policy reasons and the lack of competition in the financial market, it is impossible to carry out further interest rate reforms [14].

3. Challenges in China's interest rate liberalization reform

3.1 "Dual interest rate system"

Deposit interest rates and loan interest rates are closely related to people’s lives. At the same time, in such a situation, the term "two-way interest rate system" has appeared. The dual-track interest rate system refers to the fact that there are two systems of market-based rates and repo rates in China's financial market of fiat money. One track refers to the market side that implements the official interest rate, mainly the national bank. The other track refers to non-bank financial institutions and urban and rural credit unions that use secret methods to inflate interest rates on deposits and loans in their specific operations. The "two-track interest rate system" allows many people to take advantage of different pricing methods in different markets to arbitrage; the long-term regulation of deposit and loan spreads has led to a lack of basic risk control and pricing skills of commercial banks; the large-scale expansion impulse of commercial banks has led to a rapid expansion of broad money and the short-term shadow banking system, thereby increasing systemic risks.

3.2 Poor interest rate transmission undermines policy effectiveness

China's interest rate transmission mechanism refers to the central bank's adjustment of the benchmark interest rate centered on the Treasury bill meeting, which then influences the interbank lending rate to achieve total capital stock regulation. In recent years, China is still in the transition period and the degree of commercialization is not high. The regulation of interest rates has resulted in rates that do not depend entirely on market supply and demand. As a result, the exchange rate is inelastic and international capital flows are limited. The reasons for its existence are as follows: interest rate adjustments are linked to the interests of more parties, the central bank cannot independently decide on monetary policy, and the decision-making time is long and cannot keep up with economic developments; the strict interest rate mechanism prevents firms from varying interest rates independently, because interest rate cuts reduce the spread, which does not encourage banks to initiate loans.

3.3 Upward pressure on deposit rates after deposit rate deregulation

China has continued to make inroads on the path of interest rate market reform, and lending rates have been fully liberalized, allowing banks to let their own deposit rates float according to their own operating conditions. But in terms of expanding the space for deposit rate increases, I think the timing of deposit rate deregulation needs to be reconsidered and not rushed. For national-level banks, this is not a big issue, but for small and medium-sized banks, there may be more demand for higher interest rates. As banks generally have the inherent notion that "deposits are banks" and the search for scale. This, coupled with the fact that some regulatory indicators also place more emphasis on general deposits, has created a strong incentive for banks, especially small and medium-sized banks, to charge
high interest rates, which would not be conducive to reducing social financing costs if deposit rates were to increase [11].

3.4 Insufficient development of the government bond and Treasury bill markets

The government bond market is the collective name for the market for the issuance and circulation of government bonds. With the continuous reform of China's financial system, the commercialization of the Treasury bond market has increased. However, some corporate financing channels have not been properly improved. For example, the proportion of corporate financing remains low, especially the proportion of debt financing [12]. The banknote market is a place where banknotes are exchanged by circulation and transfer. At the same time, the bill market mechanism is not complete and there are regulatory blind spots that have not been perfected. In addition, some small firms are not able to visibly demonstrate their role in the bill market. For the state bond market, problems can arise because local state bonds are issued for the entire country, while the funds raised are only used to build a local area. For the bill market, due to the limitations received in the development scale, small businesses have poor financial management mechanisms and relatively outdated tools and concepts. Therefore, it is easy to create information asymmetry related to business interests [13].

4. Suggestions on China’s interest rate liberalization reform

4.1 Improving China's self-regulation mechanism for interest rates

In order to solve a series of problems caused by the "dual interest rate system", the government needs to liberalize the control of deposit and loan interest rates. However, in the case of non-coordination among banks, commercial banks will compete fiercely for loans and deposit users in pricing. Attracting customers by raising deposit rates and lowering loan rates may eventually lead to the bankruptcy of small and medium-sized banks highly dependent on credit assets and spreads, or even lead to local or global financial crisis.[7] And the inter-bank pricing coordination mechanism in the interest rate self-regulation mechanism restrains vicious competition. On June 21, 2019, relevant departments of China optimized the determination method of the self-regulated upper limit of deposit interest rate and decided to set the self-regulated upper limit of deposit interest rate originally formed by a certain multiple of benchmark deposit interest rate. After the implementation of the New Deal, deposit interest rate limit can rise and fall. At the same time, regulators also need to strengthen financial supervision to prevent irrational competition in the process of interest rate liberalization [8]. The supporting exit system can reduce the negative impact of the bankruptcy of some financial institutions on the whole system; a more perfect deposit insurance system is beneficial to prevent and solve financial risks and make the interest rate market develop healthily and sustainably.

4.2 Deepening LPR Reform

LPR is the loan base rate, which is the loan rate that financial institutions implement for their best customers. Through the interest rate market reform in China, LPR open market operations rates (mainly refers to MLF (medium-term loans convenient)) in the form of adding to the national inter-bank funding center (intermediary between Banks, is responsible for inter-bank foreign exchange trading, yuan interbank, bond trading system and organize the market) to offer, The loan interest rate is directly linked with monetary policy interest rate and money market interest rate, which directly realizes the guidance of policy interest rate to loan interest rate.[16] However, because the optimal customer groups among different financial institutions are quite different (for example, some customers are already optimal for small banks, but not for large banks), LPR only removes the highest and lowest values and takes the average value when calculating LPR, so the definition of LPR for different banks will be different.[3] Therefore, the state can further define how to define the optimal customers of each bank, and the regulatory authorities can uniformly define a class of customers that meet certain characteristics as the optimal customers of the bank, so as to enhance the authority of LPR.
4.3 Improving the micro basis

The micro basis here refers to general enterprises and operational financial institutions (such as banks, securities companies, investment companies, etc.). The first point is that in the process of interest rate liberalization reform, the prerequisite for the smooth transmission of interest rate is that many operating financial institutions and general enterprises have the ability to respond and adjust quickly to the changing interest rate. Therefore, the state should continue to promote the commercialization of state-owned banks, continue to improve the corporate governance structure of commercial banks (corporate governance), strengthen the internal management of commercial banks, improve the effective incentive and restraint mechanism (including material incentive and spiritual incentive). The internal banking industry also needs to improve the quality of business operation, further improve the risk management and compensation mechanism, improve the self-restraint ability of commercial banks, strengthen the research on the market, and cultivate the ability to master the market. Finally, improve the comprehensive competitiveness of state-owned commercial banks in the market. At the same time, after interest rate liberalization, the central bank has more relaxed control over commercial banks, and commercial banks have more autonomy. Therefore, China must provide good credit system and credit environment for commercial banks to lend money. A good credit environment can also make China's monetary policy more smoothly conducted and the effect of monetary policy more ideal.

4.4 Improving the Central Bank's Monetary Policy Regulatory Tools

At present, MLF is the main monetary policy tool for adjusting medium-term interest rates, and the longest term of MLF is only one year. But at the same time, the LPR formed by MLF plus points has 1-year and 5-year terms. There are 3, 5, 10 and 30-year maturities in China's medium- and long-term Treasury bonds. MLF is too single. In order to enable the central bank to accurately and efficiently adjust the interest rate structure, more and richer medium- and long-term monetary policy tools can be used, such as adding 5-year MLF. According to the research of Guofeng Sun and Zhiming Duan (2016), due to the existence of "two-sector decision-making mechanism" in commercial banks, medium-term funds released by the central bank have a more obvious impact on loan interest rate than short-term funds of the same scale. Therefore, appropriately extending the maturity of monetary policy tools can provide enterprises with more stable long-term financial support, thus easing the financing barriers of enterprises. In addition, the regular operation of MLF is once a month, and only once operation makes commercial banks dependent and reduces the active debt capacity of commercial banks. Therefore, the central bank should take MLF as a tool to stabilize the medium- and long-term capital expectations of commercial banks, and grant commercial banks the right to take on independent debts under the condition that the interest rate price is stable.

4.5 Promoting the Innovation of Shibor Product

In order to promote the reform of interest rate liberalization, the People's Bank of China launched the Shanghai Interbank Offered Rate (Shibor) in 2007. Through the joint efforts of all parties for ten years, Shibor has become one of the benchmark interest rates in the money market with high recognition and wide application in China. In order to continue to promote the wide application of Shibor in various market products, the innovation of Shibor products should be gradually promoted from simple to complex. In the process of innovation, when Shibor product scale is small and the overall liquidity of bond market is insufficient, we should first choose products with active market trading and good liquidity to carry out Shibor innovation. At the same time, the regulatory authorities should further ease the restrictions on access to the Shibor derivatives market. At present, China has strict regulation on products in the derivatives market, which prevents many participants from participating in Shibor product innovation, research and development and trading. Therefore, the relaxation of access restrictions has greatly expanded the scope of market participants, brought more possibilities for product innovation, and thus accelerated the development of Shibor product market.
5. Conclusion

This article mainly discusses the issues of China’s interest rate market reform about "two-way interest rate system", interest rate transmission undermines policy effectiveness, upward pressure on deposit rates after deposit rate deregulation, and insufficient development of the government bond, ranging from benchmark deposit, loan interest rate and market interest rate to policy effects, upward pressure the national debt market and bill market. After that, this article puts forward suggestions and methods to improve the interest rate market through improving China's self-regulation mechanism for interest rates, deepening LPR formation mechanism, improving the micro basis including the responsiveness of financial institutions and general enterprises and good credit system and credit environment, improving the Central Bank's Monetary Policy Regulatory Tools and promoting the innovation of Shibor product. However, these improvements require a long-term reform of China’s markets to achieve. All in all, the authors believe that Interest Rate Liberalization Reform will be successful in the lead of these policies and suggestions, moreover, it can establish complete financial market system in China and therefore promote economic growth macroscopically [5].

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