

Financial reform**All about interest rates***by Nicholas R. Lardy*

Financial reform is the most important economic challenge that China's new leadership faces as it seeks to sustain reasonably rapid economic growth over the next 10 years. For some time there has been a consensus that the growth model of the Hu Jintao-Wen Jiabao era is broken. Hu and Wen presided over an economy in which the investment share of GDP rose by more than 10 percentage points, reaching the astonishing peak of 48% in 2011-12. But economic growth based on a super-elevated level of investment and systematic suppression of private consumption is not a viable long-run growth model. Consumption expenditure must become a much more important source of demand.

Financial reform is the most important economic challenge facing China's new leadership

Let 'em rise

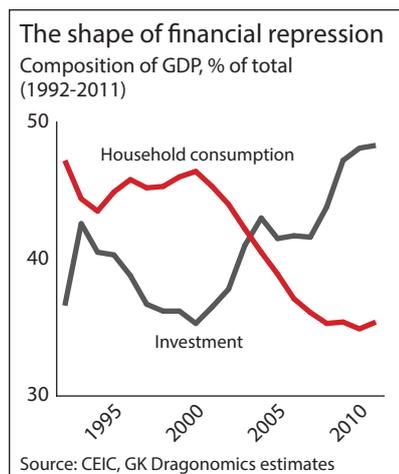
Reform of the financial sector is the single most important prerequisite for sustained economic rebalancing in favor of consumption. The key element of financial reform is not the introduction of complex financial instruments or further opening the domestic market to foreign financial institutions. It is rather eliminating the remaining government controls on interest rates on both deposits and loans, commonly referred to as market-oriented interest-rate liberalization. The People's Bank of China has long set ceilings on deposit rates and floors on lending rates. In sharp contrast with the Jiang Zemin-Zhu Rongji era, when the central bank set these rates so that households earned an average real interest rate of 3% on one-year deposits, average real returns in the Hu-Wen era were negative.

Interest-rate liberalization began under Jiang and Zhu, but was largely suspended in 2004 when the central bank allowed financial institutions to adjust their lending rates upward without limit from the benchmark rates. The ceiling on deposit rates remained unchanged until June 2012, when the central bank allowed banks to pay interest rates up to 10% above newly established, slightly lower benchmark rates on deposits. Although this small relaxation only had a marginal impact, competition for depositors compelled banks to push their deposit rates to the top of the new permitted range, suggesting strongly that market-determined deposit rates lie higher. This view is shared by leading Chinese bankers such as Xiao Gang, chairman of the Bank of China, China's fourth largest commercial bank. He has strongly supported market-oriented interest-rate liberalization, even though he anticipates it will cut net interest margins of banks by up to half.

Interest-rate liberalization lies at the heart of the changes that need to be made

Market-oriented interest-rate liberalization could be expected to contribute to China's economic rebalancing through three distinct channels. First, higher deposit rates would increase household income and thus,

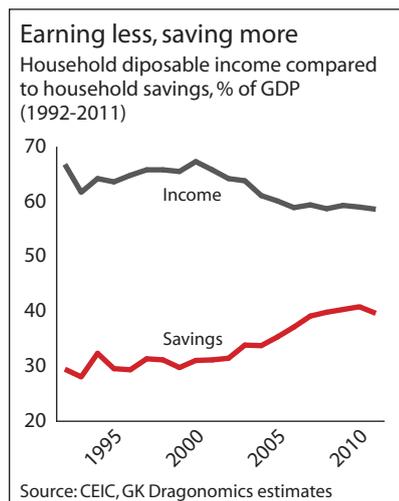
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for any given household savings rate, boost private consumption expenditure. Second, higher deposit rates would likely lower the household saving rate—also boosting private consumption expenditure. Finally, higher deposit rates will feed through in part to higher lending rates which, in turn, can be expected to increase the wage share of GDP, a key prerequisite for raising the consumption share of GDP. Since each of these channels is independent, the effects of interest-rate liberalization would be the sum of the three.

Happy shoppers...

Financial repression, in the form of lower deposit rates faced by households after 2003, contributed importantly to a reduction in household income as a share of GDP. Between 2003 and 2009 (the last year for which the detailed flow of funds accounts are available), interest earned by households on their savings deposits as a share of GDP declined by half. This occurred despite the fact that household bank deposits as a share of GDP over this period increased by more than half. In short, the stock of household saving as a share of GDP rose sharply, while the interest income generated by these deposits as a share of GDP plummeted. Market-oriented interest-rate liberalization would eliminate the financial repression that imposes a high implicit tax on Chinese savers, leading directly to higher levels of household income and household consumption expenditure.



The second channel through which interest-rate liberalization could be expected to raise household consumption is its effect on household savings behavior. The aggregate data on household savings from the flow of funds show that in the latter years of the Jiang-Zhu era (1997-2003), when the real one-year deposit rate was positive, household savings averaged 32% of disposable income. In the Hu-Wen era, when the average real rate of return on one-year deposits was negative, household savings jumped to an average of 38% of disposable income. Three separate IMF studies provide microeconomic evidence for the same inverse relationship between the real interest rate and the saving rate of Chinese households.

Data in China's flow of funds accounts allow us to estimate with some confidence that, if interest rates were liberalized, the combined effects of the first two channels would be to raise household consumption by 6 percentage points of GDP. This single policy change would reverse about two-thirds of the decline in consumption as a share of GDP seen under Hu and Wen.

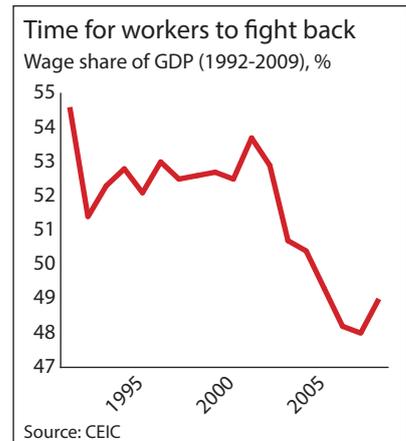
...gloomy factories

The third channel through which interest-rate liberalization would contribute to rebalancing is more complex but potentially important. In the Hu-Wen era, real lending rates fell by almost 500 basis points compared to the Jiang-Zhu era. This may seem surprising but was perfectly predictable. Low ceiling rates on deposits set by the central bank after 2003 gave commercial banks a very cheap source of funding. Competition among banks meant that a large portion of this reduced cost of funds was passed along to borrowers. This constituted an implicit subsidy for

the capital-intensive manufacturing sector at the expense of the more labor-intensive services sector, thus elevating profits in manufacturing and depressing profits in services. This tilted more investment into manufacturing at the expense of services.

The effect on the pattern of economic growth was remarkable. Between the very early 1980s and 2002, the services share of GDP increased by 1 percentage point per year, reaching 42%. But in the next decade it rose cumulatively by only a single percentage point. Since services are much more labor-intensive than manufacturing, the pattern of growth after 2002 generated many fewer jobs than would have been the case if financial repression had not lowered the cost of borrowing after 2003. The adverse effect of this on household income was compounded because service-sector jobs in China pay higher wages than those in manufacturing.

Interest-rate liberalization would reverse this process. Higher deposit rates would be passed on at least in part to borrowers, making fewer investment projects profitable. That would contribute importantly to reducing the super-elevated share of investment in GDP to a more sustainable level. Moreover, the implicit subsidy to manufacturing would erode and more service-sector jobs would be created. This would have a double-barreled positive effect on household wages, feeding through to higher consumption. The flip side is that the profit share of GDP, which soared during the Hu-Wen era, would erode. Thus an ancillary benefit of interest-rate liberalization would be to contribute to improving the



WMPs: as dangerous as they sound

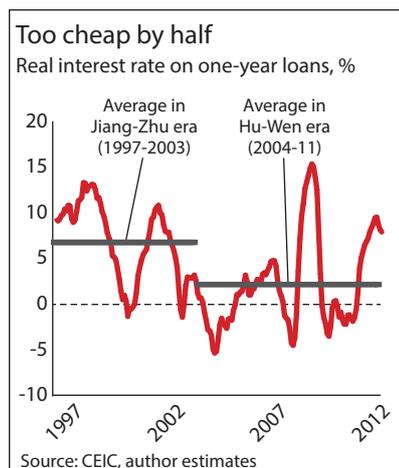
Both Moody's and Fitch Ratings argue that the emergence of wealth management products (WMPs), which typically offer savers higher nominal interest rates than bank deposits, constitutes a back door de facto liberalization of interest rates. Is this another dual-track approach to economic reform, with market-determined rates via WMPs set to wrest market share from fixed-ceiling bank deposit rates? And if so, should we not view WMPs positively, as a precursor to broader interest-rate reforms and growing household consumption?

There are several reasons to be skeptical. First, WMPs appear to be purchased disproportionately by high-income households. Banks are required to accept even very small savings deposits, but WMPs require a high minimum investment, rarely less than Rmb50,000—two years' worth of wages for workers in private enterprises. Higher yielding products often have minimum investment levels of Rmb200,000-500,000 or even more, so the higher interest earnings from WMPs accrue disproportionately to wealthier households that save an unusually high share of their incomes. They are much less likely to spend the additional income compared to less affluent households.

Second, WMPs involve potentially large risks. Almost all WMPs are relatively short term, typically 90 days, but frequently the funds raised are invested in projects with long payback periods. So when WMPs mature, trust companies and banks repay depositors with funds raised from the sale of new WMPs, rather than from the returns generated by the projects in which the funds were invested. Xiao Gang, chairman of the Bank of China, says that WMPs share certain characteristics with Ponzi schemes.

From the investor side there are other dangers. Many investors in WMPs look only at the nominal interest rate and are unaware of or unable to evaluate the risk of the products that are offered. The December 2012 default on Rmb140m of third-party wealth products marketed by Huaxia Bank underscores these risks. Regulators responded by tightening up on the issuance of WMPs.

In short, liberalization of interest rates via WMPs is a poor substitute for across-the-board, market-oriented interest-rate liberalization. The positive influence of higher earnings of WMPs on private consumption expenditure is likely to be muted, while WMPs entail substantial risks to the financial system.



Vested interests—especially property developers and other owners of capital—will resist interest-rate liberalization

distribution of income, since it would reduce the outsized gains that have accrued to capital owners over the past decade—a major source of increased income inequality in China.

Interest-rate liberalization is sometimes opposed for fear that higher rates could imperil both China's non-financial corporate sector, which currently has bank debt in excess of 100% of GDP, and China's commercial banks, which would face a much higher cost of funds. Even gradual interest-rate liberalization is likely to push some firms to the wall. Yet this should be regarded as an inevitable consequence of a decade of super-low lending rates. If banks cannot expect their borrowers to pay market-determined loan rates they will not be able to offer their depositors market-determined deposit rates. Banks could easily absorb a reduction in their net interest margins if, as expected, they struggle to pass the higher costs of funds to their borrowers. Currently Chinese banks are highly profitable, topping international leagues for return on assets, the best measure of bank profitability. But to minimize the possibility that banks would respond to potentially reduced margins by pursuing excessively risky lending, interest-rate liberalization should be accompanied by strengthened bank regulation.

The real obstacle to interest-rate liberalization is the opposition of the vested interests that have gained so much from China's imbalanced growth strategy of the past decade. That strategy benefited property developers and other owners of capital (including the state) at the expense of wage earners; the manufacturing sector at the expense of services; and China's coastal regions at the expense of interior provinces. The coastal regions benefited from imbalanced growth in part because most of China's manufacturing is concentrated in coastal regions. But this benefit was compounded by two other distortions that were important in much of the Hu-Wen era—subsidized energy and an undervalued exchange rate. Since two-thirds of China's energy production is used in manufacturing, cheap power further increased the pro-manufacturing bias of the past decade. And the low exchange rate compounded the same bias by pushing up profits on exports of manufactured goods.

Following in Deng's footsteps?

Powerful vested interests may oppose financial-sector reform, but early evidence suggests the Xi-Li leadership team will push ahead anyway. Xi's trip to Shenzhen, Zhuhai, Foshan and Guangzhou immediately after the 18th Party Congress in late 2012 and precisely 20 years after Deng Xiaoping's famous Southern Tour was a clear signal that China's incoming president intends to resume the economic reforms that were all but suspended under Hu and Wen.

China's new leaders know that reform is needed, for two reasons. First, the slower pace of growth in 2011-12 revealed structural weaknesses in the underlying growth model. There is now a widespread recognition that much of the growth of the past decade was made possible by fundamental reforms undertaken in the Jiang-Zhu era, notably the downsizing of the

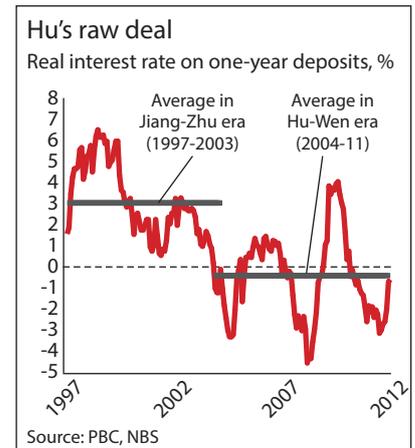
state sector in the mid-1990s and the measures to become a member of the World Trade Organization in 2001. But as the economic momentum gained by these reforms wanes, Xi and Li understand that new far-reaching reforms are needed to ensure that China's growth does not fall below the 7-8% pace now regarded as the "new normal." Second, even the vested interests understand that the legitimacy of the party and its continued rule depend on delivering reasonably rapid economic growth. Ultimately they are likely to cede some of the outsized benefits they have gained from the current growth model, rather than block reform and risk losing all.

What would a new growth path under Xi and Li look like? To sustain 7.5% growth over the decade while scaling back investment by 10 percentage points of GDP (as recommended in a recent IMF paper) would require consumption growth to run about 2 percentage points ahead of GDP growth and investment growth to decelerate very substantially. Assorted China bears argue that quicker consumption growth is unlikely, while any significant investment slowdown could drive down GDP growth to an average of about 3% for an extended period. Yet Taiwan's experience suggests rebalancing while sustaining growth is achievable. After three decades of imbalanced growth that led to a 30 percentage point reduction in the consumption share of GDP, Taiwan in the mid-1980s began a program of concerted financial reform that included capital-market, interest-rate and exchange-rate liberalization. These reforms led to a surge in private consumption expenditure that helped to sustain relatively rapid economic growth, even as net exports shrank by 10 percentage points of GDP between 1987 and 1996. There is no reason why China should not follow the same path.

All good things start here

In addition to supporting growth, liberalizing interest rates would have many other benefits. It would reduce the risk of creating asset bubbles that can accompany extended periods of negative real deposit rates. It is a prerequisite for increasing competition in the banking system, which could lead to a more efficient allocation of capital. It would facilitate the deepening of China's capital markets, paving the way for further liberalization of the capital account. And it would improve the monetary policy transmission mechanism, increasing the ability of the monetary authority to reduce macroeconomic fluctuations.

If Xi Jinping and Li Keqiang make the financial reforms needed to create a healthier model of economic growth, there is a good prospect that China's economy will grow at 7-8% for the next decade. By the end of 2022, when Xi and Li are expected to step down, China's GDP will have doubled in size—surpassing that of the US today. More importantly, personal income and consumption gains will be much larger, enabling China's citizens to share more fully in the benefits of rapid economic growth than they did in the Hu-Wen era. Liberalizing interest rates should not be viewed, therefore, as a mere tool of greater economic efficiency. It is also a path toward greater social justice.



Successful financial reform would help underpin annual economic growth of 7-8% for the next decade