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MARKETS

# China Will Free Interest Rates, as It Loosens State's Reins

*Hope Is that Competition for Savings, Within Two Years, Would Push Banks Toward Market Practices*

By LINGLING WEI and BOB DAVIS

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The People's Bank of China headquarters in Beijing. Officials hope higher deposit rates will put money into consumers' pockets. *Associated Press*

BEIJING—China's top central banker put the country on course to free up interest rates on bank deposits within two years, an unprecedented move that would force the nation's lenders to compete for customers by offering the best terms.

Officials have said they hope the shift, announced in a news conference Tuesday, will put money in the pockets of ordinary Chinese savers, make the banks evaluate risks more carefully, and direct lending to privately owned firms that complain of China's largest banks ignoring them.

But the government move to invigorate its lumbering, state-owned banking system doesn't come without

risks. Other countries have foundered in shifting their financial systems away from interest-rate restrictions, including the U.S. In the 1980s, for example, rules on the interest rates certain U.S. lenders could pay were eased, which led to the sharp growth and then collapse of many savings-and-loan firms.

China's gradual relaxing of rates is part of a broader liberalization of its economic policies, which has included giving the market a greater say in valuing the Chinese yuan and permitting more investment in China by foreigners. The market changes come even as little progress has been made on political reforms, with President [Xi Jinping](#) instead consolidating power by, for instance, assuming duties traditionally entrusted to the country's premier.

"Liberalization of the deposit rate is one of the single, most-important items on the reform agenda," said Nicholas Lardy, a China scholar with the Peterson Institute for International Economics in Washington.

Currently, the People's Bank of China maintains a cap on the rate banks can pay depositors, a system that has left Chinese households poorly compensated, because deposit rates often fall short of the rate of inflation. At present, inflation is running at about 2.5%, while a one-year deposit can pay no more than 3.3%—a level China's big banks rarely reach.

With cheap funding, large, state-owned banks channel inexpensive loans to state-owned firms, giving the borrowers a big advantage in competition with Chinese private firms and foreign competitors.

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Last summer, China scrapped controls on lending rates, although borrowers say that hasn't made much difference in the banks' practices. At the Tuesday conference, PBOC Gov. [Zhou Xiaochuan](#) said "deposit-rate liberalization is on our agenda," adding that "I personally think it's very likely to be realized in a year or two."

Mr. Zhou's statement put a concrete time around what has previously been a vague pledge by Chinese leaders to allow banks to compete for depositors. By making the forecast, the central banker—who was brought back by China's new leaders last year for a third five-year term—is publicly putting pressure for change on a system that is often stymied because of opposition from powerful interests, advisers to the PBOC said. Big banks have profited for years by paying very low rates for deposits and lending to large, state-owned firms that are seen as riskless borrowers.

"The aggressive timetable indicates the government's commitment to financial-market reform," said Eswar Prasad, a China scholar at Cornell University and a former China official at the International Monetary Fund. The PBOC isn't independent and needs approval for big changes from China's State Council, the government's top decision-making body.

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#### Relaxing the Rules

China's interest-rate change would be among recent steps taken to ease economic restrictions.

**2009:** Launched pilot program to allow some Chinese companies to use the yuan to settle international transactions

**2010:** Agreement between Hong Kong and Beijing leads to territory's development as a center of offshore yuan trading

**2012:** Foreign investors are granted

Under Mr. Zhou, the central bank has pressed to remake the Chinese economy so it is based more on domestic consumer demand, rather than exports or capital-intensive industries at home. To that end, having banks compete on deposit rates should give ordinary people more money to spend.

By boosting the cost of funding for banks, analysts say, the move could also require lenders to better analyze risks and allocate more funds to private firms that would be willing to

expanded access to China's stock markets

**2012:** The trading range for the tightly controlled Chinese yuan currency is widened

**2013:** Government controls on loans are scrapped, allowing banks to price them on their own

pay higher rates.

"Funding is a serious problem for small businesses right now," said Zhou Dewen, head of the Wenzhou Small- and Medium-Sized Enterprises Promotion Association, a trade group. "Interest-rate liberalization is key to solving the

problem."

At the Tuesday news conference, China's top banking regulator, [Shang Fulin](#), said the government will allow privately owned banks to be set up in the wealthier regions of Tianjin, Shanghai, Zhejiang and Guangdong to provide financing for cash-strapped small and private businesses. China's technology giants Alibaba Group Holding Ltd. and Tencent Holdings Ltd. [are among the companies](#) that have won regulatory approval to take part in the pilot program, according to the China Banking Regulatory Commission.

But bank-deposit liberalization has sometimes led to financial crises as banks compete for funds, pushing up their costs and leading them to make risky loans that end up badly.

In the U.S. savings-and-loan crisis, the institutions, freed to compete for deposits, made bad bets on real-estate projects as they sought borrowers willing to pay enough to cover the lenders' higher cost of funds. Many developers couldn't repay their loans, and more than 1,600 banks were closed at a cost of \$160 billion, according to a study by the U.S. Federal Deposit Insurance Corp.

In the case of China, a surge in interest rates—a potential response to a rise in the amount banks pay to depositors—could put further pressure on local governments, real-estate developers and other companies already struggling to repay debt. Outstanding bank loans and bond debt among nonfinancial Chinese companies reached about \$12 trillion at the end of last year, representing more than 120% of China's gross domestic product, according to Standard & Poor's.

Banks' inability to offer higher deposit rates has also fueled the growth of less regulated informal lenders that are willing to pay more.

In many cases, Chinese banks work with so-called trust firms to attract savers through high-yielding investment products and lend the money to high-risk sectors, including property developers and cash-strapped local governments, without having to book the loans on their balance sheets.

Such "shadow banking" activities have led to a jump in China's overall debt levels in the past few years, leading to concerns over the country's financial vulnerability as its economic growth slows.

"The rapid development of shadow banking, including Internet banking, is de facto interest-rate liberalization," said UBS AG China economist Wang Tao.

Allowing banks to compete on interest rates would boost lending rates, at least in the beginning, according to bankers and analysts. That is because banks would be forced to fight for customers by offering higher rates on deposits and, in turn, charging more for loans. Even so, that is widely seen as a plus to the overall economy, because it would force banks to more carefully assess their customers in terms of their ability to pay—rather than their political clout—and could funnel more money to private firms in the service and high-technology fields.

The PBOC has been working with the IMF on how to liberalize deposit rates safely. The IMF has urged the Chinese central bank to "sequence" the change by first putting in place a bank deposit-insurance system and

a mechanism for handling banks that go broke after they have greater freedom to chase deposits through higher interest rates. In a report to lawmakers last week, Premier [Li Keqiang](#) pledged to do both.

It is far from clear how the central bank would put liberalization into effect.

Currently, banks are permitted to charge a rate on loans 10% higher than the benchmark deposit rate, which is now 3%. One possibility is increasing that range to, say, 30%. Another is to allow full liberalization of longer-term deposits, says an official familiar with the PBOC's deliberations.

"In the short term, liberalization could lead to a rise in interest rates," Gov. Zhou said at the news conference.

"But eventually, interest rates will be determined by market forces."

—Matt Day

contributed to this article.

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