Interest-Rate Liberalization in China

A Commentary by Steven Dunaway, Deputy Director
and Eswar Prasad, Division Chief of the China Division
Asia and Pacific Department
International Monetary Fund
Published in *International Herald Tribune*
December 4, 2004

Modernizing economies I

The People's Bank of China recently surprised financial markets by raising interest rates for the first time in nine years. This was an important step, as it signaled the authorities' desire to move toward more market-oriented measures to control credit and investment growth. It also launched a great deal of public discussion focused on how effective these rate increases would be in slowing economic growth and whether this action could be a precursor to an exchange rate change.

But lost in all of this commentary appears to be adequate recognition of an even more important change in interest rate policy that took place at the same time and that is likely to have long-lasting ramifications—the removal of ceilings on lending rates. Until this change, most banks were limited in what they could charge on loans to a rate that was at most one and three-quarter times the base lending rate set by the central bank.

Improving the efficiency of financial intermediation is a key priority to ensure sustained and stable growth in China over the medium term and a major reason behind the authorities' renewed push to reform the banking system. This liberalization of lending rates is an important step toward increasing the commercial orientation of banks. It gives them the ability to price loans more appropriately to reflect the riskiness of the borrowers and provides them incentives to develop new loan customers, especially among small and medium-sized private enterprises (SMEs).

At present, the SMEs are generally considered by the banks to be more risky than their traditional customers (mainly the larger state-owned enterprises), largely owing to difficulties in assessing creditworthiness because of serious deficiencies in the availability of financial information. But improving access to credit for the SMEs is critical to China's future because they tend to be, on average, more dynamic than the state-sector enterprises in generating jobs and growth. The ability to charge higher rates on loans can compensate the banks for the perceived riskiness of the SMEs and provide incentives (as well as resources) to build up credit information on borrowers. Thus, in time, banks can become more effective in directing China's prodigious national savings to those investments yielding the highest return to the economy.

Skeptics may question why this change should have much of an effect, since banks were not using the flexibility that they had even earlier. Indeed, after the ceiling on lending rates was raised earlier this year, there were reports that state commercial banks were still making few loans, if any, above the base lending rate. One problem may simply have been that the degree of flexibility was just not sufficient to account for the degree of riskiness of private-sector firms. After all, in an economy where there is no strong legal framework for enforcing creditors' rights, all of the risks associated with a loan would have to be priced into the interest rate.

It will of course take banks time to develop their risk assessment capabilities and credit information systems. During this learning period, effective prudential supervision will be essential to ensure that they carefully evaluate projects on a commercial basis and make adequate provisions to account for the riskiness of their loan portfolios.

Being able to price loans flexibly will improve the profitability of China's banks as it provides an opportunity for banks to raise their margins. In turn, increased profitability will enhance the ability of the banks to deal with their existing problems with the nonperforming loans on their books, and will make it easier for the banks to raise new capital.

In time, this liberalization will enable market forces to play a greater role in determining the allocation of credit, and will result in an economy more responsive to changes in rates. This will have the added benefit for the authorities of enhancing the effectiveness of monetary policy as an indirect, market-oriented means of controlling economic activity, reducing the need to use administrative measures and avoiding the distortions that such measures create.

So, in the end, this overlooked change in lending rate policy is likely to be the most important one made. The liberalization of rates is a landmark change, and it represents another major milestone in China's transformation to a market economy.