Economic Analysis

The PBoC's new CDs guidelines indicate that China's interest rate liberalization is close to completion

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Yesterday, the People's Bank of China (PBoC) promulgated guidelines to allow banks to issue certificates of deposit (CDs) to individual investors and non-financial institutions, paving the way for full interest rate liberalization. According to the guidelines, the CDs have nine maturities ranging from one month to five years while their floating rates are to be determined on a market basis and linked to the Shanghai Interbank Offered Rate (SHIBOR). The CDs will be tradable in the secondary market and will be covered by China's newly introduced deposit insurance scheme. The holders of the CDs are subject to certain minimum thresholds: RMB 300 thousand for individual investors and RMB 10 million for non-financial institutions.

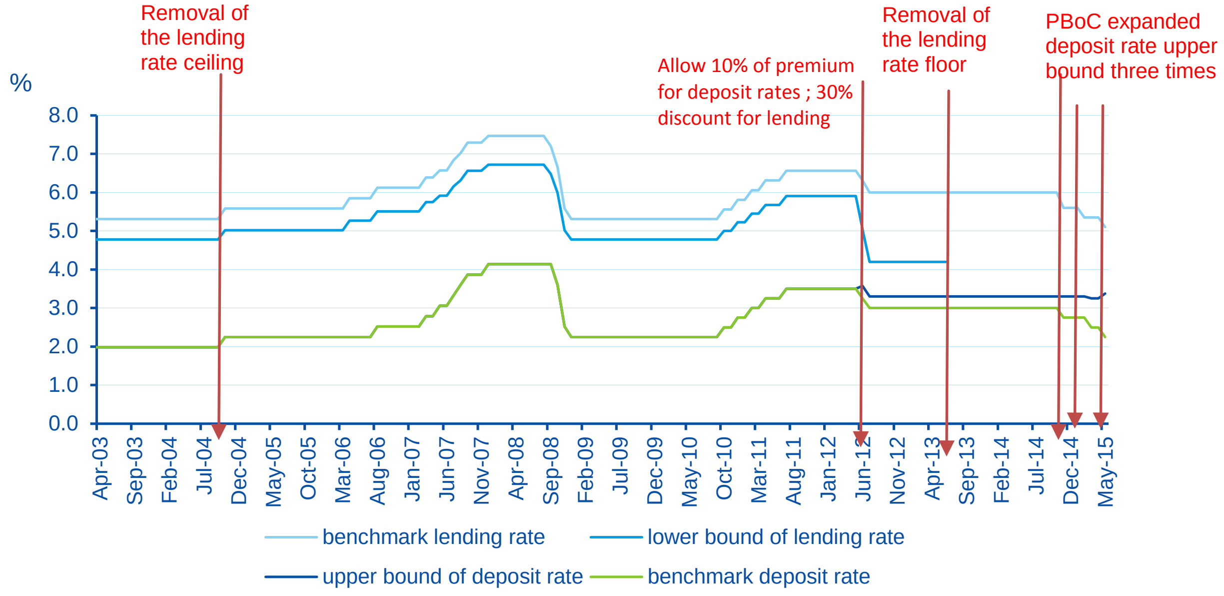
- **Interest rate liberalization is anticipated to complete soon...**

The move is another milestone in China's long-lasting process of interest rate liberalization. Indeed, the PBoC had already introduced the CDs for financial institutions since late 2013. However, as interest rates in the interbank market are not subject to the PBoC's regulation, the CDs for financial institutions only have a symbolic meaning for interest rate liberalization. Comparatively, the expansion of the CDs holders to individual and non-financial institutional investors is much more important because it gives banks the real pricing power for customer deposits, albeit limited by the abovementioned minimum thresholds. Now with the CDs for individual investors and non-financial institutions, it is much easier for the authorities to lift the existing cap on deposit rates (1.5 multiples of the benchmark deposit rates) and to complete China's interest rate liberalization. (Figure 1) We anticipate this final step to be made in the second half of this year, most likely being accompanied by one of additional interest rate cuts.

- **…with more challenges lying ahead**

The completion of interest rate liberalization is set to bring about a number of new challenges to the slowed economy. First, the liberalized fund market could lead to fierce competition among banks vying for deposits. Consequentially, banks' interest rate margin as well as their profitability will be further squeezed by the fast rising deposit rates; second, the CDs will compete with the wealth management products (WMPs) for household deposits in the short term, which could increase the risk of liquidity drain in the shadow banking sector; last but not least, the lift of the deposit rate cap also means that the PBoC will lose one of important monetary policy tools. In theory, interest rate cuts can no longer have any real impact on the economy other than indicating the authorities' policy directions. The PBoC therefore needs to adjust its monetary policy framework to match with a banking sector with liberalized interest rates.

Figure 1
The CDs guidelines indicate China's interest rate liberalization process is close to complete



Source: CEIC and BBVA Research