China Flash

PBoC's removal of lending rate floor: little immediate impact, but good in the long run for interest rate liberalization

The People's Bank of China (PBoC) late on Friday announced the removal of the lending rate floor, an important, but by no means final step, toward interest rate liberalization in China. A binding deposit rate cap remains in place. With effect from July 20, Friday's announcement removed: (i) the lending rate floor on bank loans (which had been set at 70% of the benchmark lending rate); (ii) controls on the price setting of banks' bill discounting; and (iii) lending rate caps (previously set at 2.3x the benchmark lending rate) on rural credit unions. Importantly, the PBoC kept the floor on mortgage rates unchanged (70% of benchmark rates) in a sign of its continued concern about rising housing prices. The removal of the lending rate floor will have little immediate impact since it was not currently a binding constraint (banks were not making use of the 30% permissible discount provided last year, see Charts 1 and 2). Nevertheless it is a further step toward interest rate liberalization and may reduce the cost of credit to some of the large enterprises. The step should be seen in the context of the broader financial liberalization effort (*see Banking Watch*), with the next significant step awaiting further upward flexibility in deposit rates.

- **The step will have a beneficial effect on borrowers, albeit very limited.** According to PBoC data, as of end-March only 11.4% of outstanding loans carried an interest rate below the benchmark (data is not provided on how far below). Therefore, the overall impact on lending rates should be limited at this time. Large state-owned-enterprises (SOEs), who have stronger bargaining power with banks, may benefit. Also, the removal of controls on the pricing of bill financing together with the removal of the interest rate cap on rural credit unions may increase the flow of credit to SMEs.

- **Bank profits will decline from interest rate liberalization, but this step will have only a very small impact**. Given the limited impact on actual lending rates, the announced measures will do little to narrowing interest rate margins. However, going forward, we have projected qa decline in bank profit growth as interest rate liberalization proceeds (*see Banking Watch on profit outlook.*) Reflecting this, China bank shares fell in early trading today.

- **Why now?** In recent years the authorities have taken a gradual and step-by-step approach toward economic reforms. This current measure is such a step, and is in line with the new leadership's emphasis on pressing ahead with reforms to rebalance the economy. Further interest rate liberalization, including on the deposit rate side, would lead to a more efficient allocation of credit and improve the return to savers. The eventual removal of caps on deposit rates would also be an important step toward reducing the role of the shadow banking system and its related risks by reducing the incentive for banks to issue higher-yielding wealth management products.

- **Next steps?** The authorities outlined their liberalization goals in the 5-year Financial Sector Plan released in September 2012, but without providing a roadmap or timetable. The next significant step toward interest rate liberalization, in our view, would be to allow greater flexibility in the setting of deposit rates by increasing the allowable margin over the benchmark deposit rate (currently 10%) and/or selectively removing the deposit cap on certain products such as CDs. However, full liberalization of interest rates is unlikely before the end of 2015, by which time a deposit insurance scheme may be in place. Meanwhile, capital account liberalization and the full flexibility of the RMB, is likely to take somewhat longer, and not before 2017-20. In the coming months we expect further steps toward exchange rate flexibility (another widening of the daily trading band), and further expansions in overseas investment programs (QFII, RQFII, and QDII).

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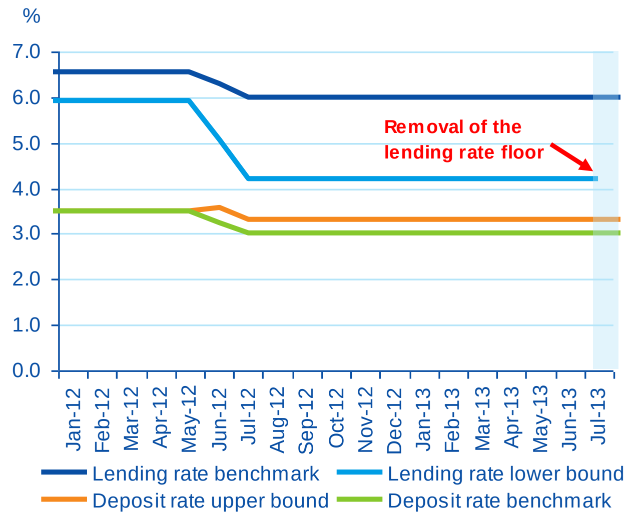
Chart 1

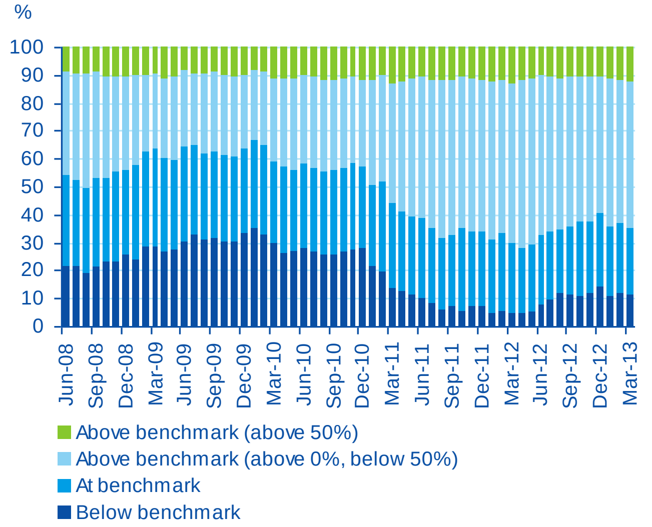
The lending rate floor has been removed, after the greater flexibility introduced last year…



Source: CEIC and BBVA Research

Chart 2

…but few loans are currently priced below the benchmark, so the move will have only a limited impact for now



Source: CEIC and BBVA Research

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