Orient Capital Research

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# China Banks

## Can China Afford to Liberalize Interest Rates?

**What Happens to the Renminbi?**

Two weeks ago, People's Bank of China Governor Zhou Xiaochuan said China would liberalize interest rates for consumer deposits within two years, a surprisingly frank timeline on a controversial subject.

Economists inside and outside of China have been clamoring for liberalized interest rates for some time. The argument for freeing up interest rates in China is quite simple. For borrowers, capital would be allocated according to its returns and not due to the whims of the state. Savers across the country would no longer be forced to accept below market returns. Consumers would have more money in their pockets, and the much hoped for rebalancing of the economy from industry to consumption would be given a quick kick.

However, the reality is not simple. Liberalized interest rates would cause a chain reaction of problems in the financial system, all because of the government's decision to keep the value of Renminbi in a tight range. Unraveling that deal could lead to a cat fight among the key financial institutions, including the PBOC, the State Banks, and the Ministry of Finance.

The reason for the potential for political jockeying stems from the government's policy of keeping the RMB within a fixed band. Every time a company makes a sale overseas, it is paid in foreign exchange. As explained by Chenyang Zhang in a paper at Wharton:

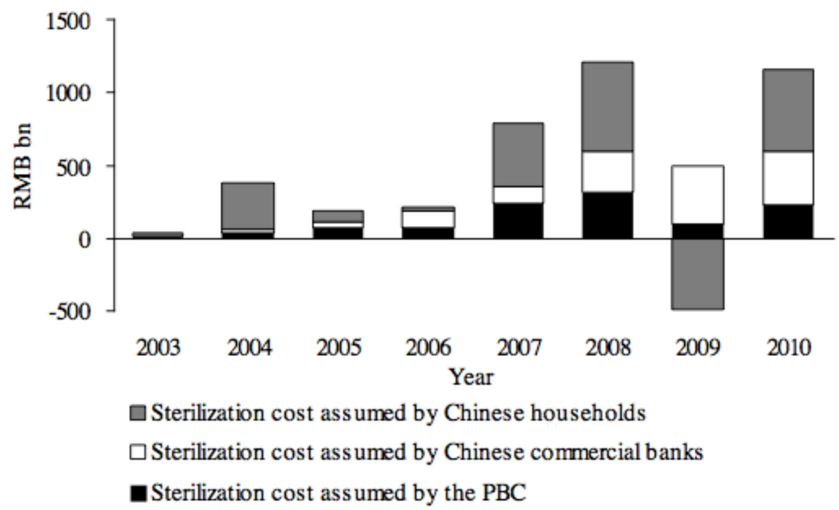
"When the Central Bank buys foreign currency from a local exporter, it has to pay the exporter in local currency. The exporter then can deposit the currency in commercial banks. This raises the bank's reserve level above the minimum level of required reserves and enables the bank to expand loans. Consequently, the bank's balance sheet will show an increase in foreign assets and an increase in the reserve money on the liability side. An increase in reserves, *ceteris paribus*, causes monetary expansion and thus puts inflationary pressures on the economy, resulting in an appreciation of the real exchange rate. For these reasons, the accumulation of foreign reserves poses a challenge for domestic macroeconomic management."

In order to prevent this inflationary monetary expansion, the money coming into the country is *sterilized*. This is done by selling bonds to the banks and thus preventing the expansion of the monetary base. A second method is to raise the Reserve Requirement Ratio (RRR), withdrawing funds from the system. But at what cost? The bonds must be issued with a price – the interest rate. The PBOC's overseas holdings of US Treasuries provide a return lower than what it has to offer to banks in China to persuade them to purchase the sterilization bonds. Historically, the interest rate difference between US Treasuries and Chinese Central Bank Bills has been one or two percentage points. Zhang Ming, from the Chinese Academy of Social Sciences, using a variety of assumptions estimates that sterilization costs close to 1 trillion RMB. As foreign exchange holdings have ballooned, the cost has escalated.

The real risk is that the sterilization costs – if born by the government alone – eventually would bankrupt the central bank. So to avoid this calamity, a tacit deal was struck to share the costs of the process between the PBOC, the State Banks, and consumers (clearly without their say so). The guts of the deal are: the Banks agree to buy central bank bills at below market rates, and also to park a large chunk of their capital (now at around in 20%) in the PBOC in the form of reserves (RRR). Meanwhile, to ease the burden on the banks, the PBOC has allowed them to freeze deposit rates at around 3%, thus guaranteeing a profit from the spread between deposit and lending rates.

**Estimates of Sterilization Cost**

**Figure 4. Sharing of Sterilization Costs among the People's Bank of China, Chinese Commercial Banks and Chinese Households**




Source: Zhang Ming, CASS

But this whole economic contract threatens to unwind if deposit rates are deregulated, as Governor Zhou has suggested. Savers (i.e. consumers) would get a big boost in income – but unless measures are instituted to offset the new rules, the banks would be big losers.

**Can the Banks Afford Liberalized Interest Rates?**

The State Banks won't be happy to be losing an important part of their profits coming from the interest rate spread. Below is a back-of-the-envelope analysis of the potential loss of income for the four state banks (ceteris paribus). We took the retail deposits of the four state banks and their interest paid. Then we used two scenarios for interest rates paid to depositors, both from the Bank of China's financial statements: one is the interest paid to borrow money from the Central Bank and from other banks (2.17%); and the second is the general rate paid to borrow funds from other sources (3.56%).

| Payment by Four State Banks to Retail Customers | Retail Deposits | Interest Rate | Actual Interest Paid | Interest Paid Scenarios | 1H 2013 Net Income | Net Income Scenarios | % Chang |
|---|---|---|---|---|---|---|---|
| Due to Customers | 22,545,201 | 1.86% | 263,151 | *NA* | 434,744 | *434,744* | |
| *Increase due to Use of Banks Interest Rate* | *22,545,201* | *2.17%* | *489,231* | *226,080* | *434,744* | *208,664* | *-52* |
| *Increase due to use of Other Borrowed Funds Rate* | *22,545,201* | *3.56%* | *802,609* | *539,458* | *434,744* | *(104,714)* | *-124* |

If the banks paid interest based on interest paid to other banks of 2.18%, their combined net income would drop 53% to 206.4 billion RMB. If they switched to the yet higher rate paid to "other" lenders of 3.56%, the banks would report a loss of 104.7 billion.

Admittedly, these are just ballpark estimates as it is not certain what rate would be used to pay savers. Also, and we haven't calculated any changes to lending rates to keep the banks' interest rate spread, a suggestion made by some academics.

**Would the Ministry of Finance Step In?**

Would the PBOC agree to help increase the banks profits to make up for the loss to retail customers? They can do this in several ways:

1) Reduce the RRR;
2) Agree to pay a higher interest rate for bank bills
3) Guarantee the state banks interest spread.

We took a look at one change, lowering the RRR to 6%, which is a commonly accepted level among banks globally and much lower than the Chinese level. That cash can now generate income through new loans. If we use the rate of 3.13% the Bank of China pays for debt securities, total bank profits would rise 24% to 538.8 billion RMB. Using the higher rate paid for loans of 5.62%, the profit rises 59% to 689.4 billion RMB.

| Payment by PBOC to Banks | RRR | Interest Rate | Actual Interest Earned | Interest Earned Scenarios | 1H 2013 Net Income | Net Income Scenarios | % Chang |
|---|---|---|---|---|---|---|---|
| Balances with Central Banks (6% RRR) | 6,889,642 | 1.41% | 85,276.2 | *NA* | 434,744 | *NA* | |
| Scenario One - Interest Rate Used for BOC Loans | 6,889,642 | 5.62% | 339,895.2 | ***254,619*** | 434,744 | *689,363* | 59 |
| Scenario Two - Interest Paid for Debt Securities | 6,889,642 | 3.13% | 189,301.1 | ***104,025*** | 434,744 | 538,769 | 24 |

**It's All Down to Politics**

These scenarios are highly speculative but do give a sense of the scope of the problem: abandoning a decades old deal to share the cost of a fixed currency would be costly.

Is a deal possible? Zhou Xiaochuan wouldn't have made his statement unless he thought interest reform was a possibility. But the State Banks may fight back. Combined, they have 1.5 million employees. More important, they have a total of 61,786 branches, which gives them quite a bit of power among local governments. However, in the 1990s, Zhu Rongji forced local branches to be accountable to Beijing and not to local governments, forcing the banks to become more disciplined and no longer prey to the financial demands of local governments. Also, the banks' Chairmen are appointed directly by the State Council. Still, the banks have at least one-quarter public float and do have responsibilities to make a profit and are likely to fight any attempt to reduce that.

The benefits of interest rate liberalization are numerous, including a more transparent financial system, a shift away from property as a store of wealth, and an increase in consumer income. It's clear, though, that getting to that point is going to be a long, messy road.