Interest Rate Determination in China: Past, Present, and Future

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Summary

The Chinese authorities have recently announced plans to speed up the pace of interest rate liberalisation, raising expectations that the process will culminate with a final removal of the ceilings on deposit rates in the medium term. Accompanying the process will be an overhaul of the monetary policy framework, from a focus on credit targets to a focus on the level of interest rates, and an expansion of the fixed income markets, facilitating the formation of a complete risk free yield curve.

How should we think about the determination of interest rates in China after interest rate liberalisation? Would effective deposit rates, lending rates and bond yields move higher or lower? We argue that interest rates in a liberalised environment would need to be anchored by the conduct of monetary policy. If monetary policy is to achieve the objective of price and output (or employment) stabilisation, the policy rate should be set close to China's equilibrium or natural rate. We sketch three preliminary approaches to estimation of the real natural rate, which lead to largely consistent estimates around 4 to 4.5% for China. Based on this analysis, we argue that interest rates on large deposits in the banking system and short term money market rates would likely to move higher following interest rate liberalisation. The effect on effective lending rates is ambiguous as the contestability of the banking sector and the competition from the bond markets are likely to increase after interest rate liberalisation. We leave the determination of the curvature of the yield curve to future research.

At present, the ceilings on deposit rates are imposed by the PBC through administrative orders. After interest rate liberalisation, the PBC will use the composition and size of its own balance sheet to influence market rates. As the monopoly supplier of high powered money, the PBC will be in a position to anchor short term interest rates. As an interim measure, the PBC may still consider setting targets for medium term interest rates and managing the shape of the yield curve through direct interventions in the bond markets. The case for managing the yield curve is strong since the bond markets will take time to expand and mature to enable the development of a smooth yield curve determined by market forces.