

Getting interest rates to work: Will the latest overhaul of deposit rates drive more effective monetary policy?

The central bank (PBoC) has long acknowledged that a weak transmission mechanism has hampered the effectiveness of monetary policy in China. It's been trying for years to put that right – and may finally have cracked it.

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Key takeaways

- The PBoC wants to change how it manages the economy, shifting from regulating the money supply to using interest rates instead.
- It's been putting the building blocks in place for years, but one of the key obstacles to achieving its goal has been weak monetary policy transmission.
- Changes in April to how banks set deposit rates might finally provide the solution. The PBoC is hoping that the new regime will improve its ability to influence the national loan prime rate (LPR), its key benchmark lending rate, creating a domino effect on all other interest rates, and giving the PBoC the same leverage over monetary policy that the US Federal Reserve has.
- The PBoC is asking banks to adjust their short-term deposit rates to reflect changes in the national LPR and their long-term deposit rates to reflect the yield on 10-year Chinese government bonds (CGBs). As an incentive, it has offered banks additional points on their macroprudential assessments if they comply. Higher macroprudential scores entitle banks to a higher interest rate on reserves held at the central bank.
- These incentives mean banks should be more willing to adjust their deposit and lending rates in response to changes the PBoC makes to the interest rate on funds it loans large banks under the medium-term lending facility (MLF). Until now, deposit rates and the LPR haven't been sensitive enough to changes in the MLF rate – which is the root of the transmission problem.
- The PBoC is already claiming success. At the end of June, the weighted average interest rate on new bank deposits was 2.32%, 0.12 percentage points lower than in April, before the introduction of the new mechanism.
- However, competition among banks for deposits is cut-throat, and the PBoC needs to find a way to stop that scramble. Only then can it declare total victory, and truly gain the power to manage the price of credit throughout the economy.

The People's Bank of China (PBoC) has long acknowledged that a weak transmission mechanism has hampered the effectiveness of monetary policy in China. The central bank's been trying for years to make that right – and may have finally cracked it.

At a recent [press conference](#), a Bloomberg reporter asked Zou Lan, director of the People's Bank of China's (PBoC) monetary policy department, whether there was space for a reduction in the loan prime rate (LPR) in the second half of 2022. The curious thing about Zou's answer is that he barely mentioned the LPR. Instead, his response was entirely focused on deposit rates.

What's going on?

The PBoC thinks it has finally found a way to adjust the cost of credit throughout the banking system by changing one policy rate. This is how the US Federal Reserve works, and most other central banks around the world. However, until recently, China has managed the economy by regulating the supply of money rather than its cost, using tools like banks' reserve requirement ratio. For the last few years, it's been gradually moving toward a system more like that of its peers who rely on interest rates as their primary monetary policy lever.

So far, it's had mixed success. But changes introduced in April to how banks set their deposit rates might be the key to unlocking the door. Those changes will potentially allow the PBoC to adjust the LPR by changing the interest rate on the medium-term lending facility (MLF) – which has been the PBoC's stated goal since 2019.

This report outlines how the interest rate framework put in place by the PBoC looks very similar to that used by the US Federal Reserve, and how the PBoC's failures over the last few years led to the April reforms.

Target rates

To understand what the PBoC is trying to achieve, it's useful to reflect on how the US Federal Reserve manages the US economy.

The US has three main interest rates:

- **Federal Funds Rate:** The interest rate banks charge when they lend excess reserves to each other overnight.
- **Prime rate:** The rate at which banks lend to their best corporate customers. Each bank has its own prime rate, but an aggregate rate is published by the Wall Street Journal.
- **Yield on 10-year US Treasury bonds:** The Treasury issues securities with maturities of three months, six months, two years, three years, five years, 10 years, and 30 years. The most important of these is the 10-year because it's used as the reference to set interest rates for home mortgages.

The Federal Reserve can guide the level of all three rates by managing the Fed funds rate. The Federal Open Markets Committee (FOMC) meets eight times a year to set a target range for the Fed funds rate. However, while the FOMC sets a target, the actual interest rate at which banks lend to each other is decided by the banks themselves. To keep

bank lending within the FOMC's range, the Fed injects funds into, or withdraws funds from, the banking system through daily open market operations (OMO). An injection of funds via OMO means the Fed lends to banks, which increases the resources they have to lend to each other, thereby reducing the interest rate on those loans. A withdrawal has the opposite effect.

By changing the interest rate at which banks lend to each other, the Fed can influence all other interest rates. An increase in the Fed funds rate raises the prime rate and the yield on 10-year Treasuries by increasing banks' funding costs and vice versa. (But note: Treasury yields are also influenced by other factors like inflation and economic growth expectations). Consequently, the Fed can increase or decrease the demand for home mortgages and corporate loans just by managing the interest rate on ultra-short-term loans between banks.

The PBoC has set up a similar framework of interest rates. However, it's not yet as effective as the Fed at managing the economy using those rates.

Short-term interbank rates – DR007

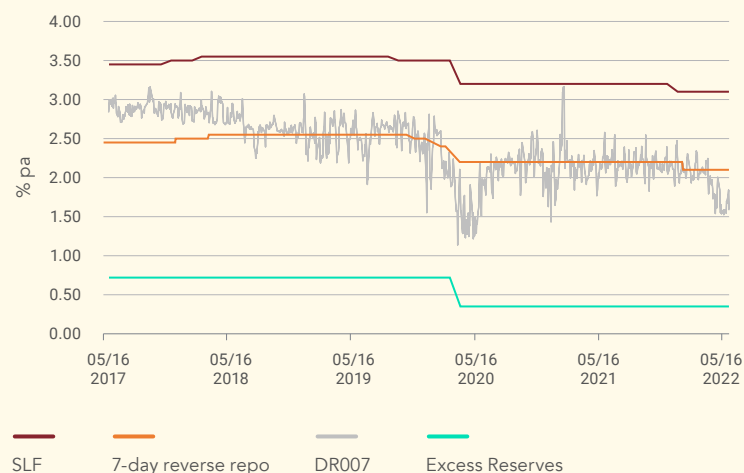
Instead of targeting rates on overnight lending between banks, the PBoC seeks to manage the interest rate banks charge each other for collateralized loans lent out under seven-day repo contracts – a rate referred to in the markets as DR007.

In early 2021, the PBoC announced that it would decide whether to add or withdraw liquidity from the banking system during daily OMOs based on movements in DR007, which it keeps within a formal corridor – the floor is the interest rate it pays on banks' excess reserves and the ceiling is the interest rate it pays on funds it lends through the short-term lending facility (SLF). The SLF is the tool it uses to make ultra-short-term collateralized loans to banks and is an emergency facility to help banks tap liquidity when they cannot borrow from the market. As the PBoC wants banks to use SLF in emergencies only, it keeps the interest rate above market rates.

The corridor is pretty wide. The interest rate on excess reserves is currently 0.35%. The seven-day SLF is 3.10%. Usually, the PBoC tries to keep DR007 around the interest rate it charges on seven-day reverse repos issued during OMOs. If DR007 deviates too much from that level, the PBoC pulls it back in line by injecting or withdrawing liquidity [Fig. 1].

In this way, the PBoC can regulate the interest rate at which banks lend to each other. However, while the Fed can manage the cost of credit throughout the entire economy through the fed funds rate, changes to the DR007 don't flow through to interest rates on other types of lending.

Fig. 1 – Key short-term interbank interest rates



Source: CEIC

Loan prime rate (LPR)

China's national loan prime rate (LPR) is the equivalent of the US aggregate prime rate. There are two LPRs – one for one-year loans and one for five-year-plus loans. They are both calculated by the PBoC based on the interest rates that a group of 18 banks charge their best customers for one-year and five-year loans. Banks then use the national LPRs as a reference point – a benchmark – for pricing other loans, including home mortgages. Consequently, when the LPRs change, interest rates on all business, retail, and home loans change.

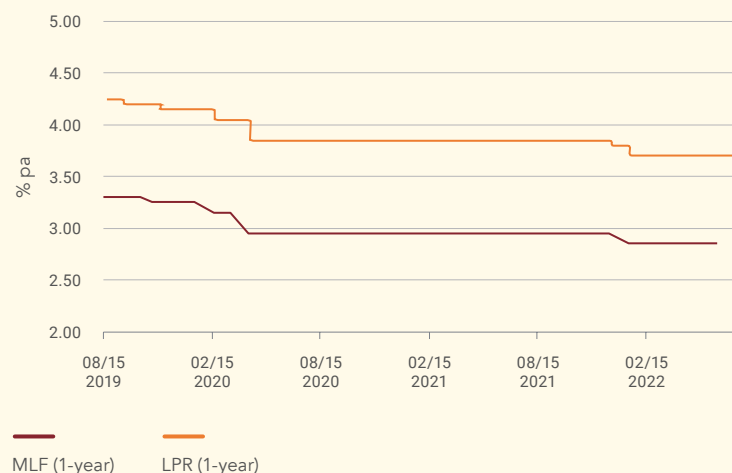
The PBoC wants to be able to manage the LPR by changing the interest rate it offers on funds it lends to banks via the MLF. Under the MLF, the PBoC provides funds to the financial system by making one-year collateralized loans to large financial institutions [Fig. 2].

Reducing the MLF rate reduces banks' cost of funding, and, in theory, they pass the savings on to borrowers. In some cases, they do. According to an essay by PBoC Governor Yi Gang in 2021, the one-year yield on AAA+ rated negotiable certificates of deposits (NCDs) issued by banks typically moves around the MLF rate.

However, the interest rate the PBoC really wants to influence via changes to the MLF is the LPR, but this has proven more difficult.

The problem is that banks get most of their funding from deposits, meaning that deposit rates have to decline before banks will willingly cut lending rates. Otherwise, their net interest margin, which accounts for the bulk of their profits, declines. In a perfect world, a cut to the MLF rate – or even a decline in DR007 – would be a signal to banks to cut deposit rates. That's not what happens in China.

Fig. 2 – MLF vs LPR



Source: CEIC

Deposit rates are the key

In China, savers prefer to deposit their money with large banks, which have a reputation for being safer and better managed than city and rural commercial banks, and village banks, which leaves the latter constantly scrambling for deposits.

The PBoC has removed most of the restrictions on interest rates, but one of the few that remains is an upper limit on deposit rates, which is aimed at preventing small lenders from paying too much to attract deposits. Even so, small banks offer the highest rates permitted, forcing other, large banks to offer higher interest rates than they otherwise would.

“Due to the intense competition in the deposit market, many banks’ interest rates on time deposits and large certificates of deposit are close to the...cap,” the PBoC said in May 2022. “This hinders the effective transmission of market interest rates and makes it difficult for deposit rates to follow changes in market interest rates.”

Consequently, for the PBoC to lower the LPR, it needs to find some mechanism to reduce deposit rates. Of course, it could just resort to telling banks to cut the LPR without an offsetting decline in deposit rates, forcing them to accept lower profit margins. However, the whole point is to move away from administrative orders and window guidance.

Throughout 2021 and 2022, the PBoC has done both. It’s made repeated calls for lower lending rates, which has put pressure on net interest margins. But it has also taken steps to try to come up with this elusive mechanism.

In June 2021, the PBoC changed how it calculates the upper limit on deposit rates. Previously, it set a benchmark rate, and banks were permitted to offer customers a certain percentage above that rate – national banks were allowed to offer up to 1.4 times the benchmark, while smaller banks were allowed to offer more. But in June, the central

bank made a switch – the deposit rate ceiling was set at a predetermined number of basis points above the benchmark. Large banks can set rates up to a 50-bps premium, and small banks up to a 75-bps premium. The rationale for the change was that the deposit rate curve was too steep. The reform flattened the curve, lowering long-term rates and raising short-term rates.

The net effect was to bring down banks' overall funding costs. According to the PBoC, the weighted-average interest rate of banks' new time deposits in December 2021 was 2.30%, 19 basis points lower than in May, before the reform. In an essay published in January, Sun Guofeng, who was director of the PBoC's monetary policy department at the time, wrote that this drop paved the way for the LPR to decline by 5 bps in December and a further 10 bps in January.

Macroprudential solutions

However, this is not how the PBoC wants to manage interest rates. According to Yi Gang, the PBoC wants "a transmission from MLF rates, to LPRs, and then to other lending rates, thus greatly smoothing the transmission channel of monetary policies."

The PBoC's latest solution is the Self-Discipline Mechanism for Market Interest Rate Pricing, a banking industry body overseen by the PBoC that emerged in April. This body is tasked with encouraging banks to adjust deposit rates in line with changes in the LPR and the yield on 10-year CGBs. According to Caixin, banks that comply will receive extra points on their macroprudential assessment, a framework the PBoC uses to judge banks' overall health. Banks with higher scores get paid a higher interest rate on the reserves they're required to hold at the PBoC.

However, Caixin also reports that the PBoC is only offering a 5-basis-point boost for compliance, which might not be enough to achieve the radical shift in behavior the central bank wants.

Still, the PBoC is claiming success. According to Zou Lan, at the end of June, the weighted average interest rate on new bank deposits was 2.32%, 0.12 percentage points lower than in April, before the introduction of the new mechanism. Zou said:

"The establishment of the market-based adjustment mechanism for deposit interest rates has significantly improved the market-based pricing power of deposit interest rates, which is conducive to maintaining a good competitive order in the deposit market, stabilizing the cost of bank liabilities, and promoting the reduction of real loan interest rates."

Are we there yet?

Despite Zou's upbeat assessment, we haven't yet got to the point where we can say the PBoC has truly cracked the monetary policy transmission nut.

Using macroprudential incentives to lower deposit rates isn't a lasting solution, nor is it one that allows the central bank to withdraw and watch

the invisible hand of the market work. The PBoC still needs to find a way to reduce competition among banks for deposits so that it can remove the upper limit on deposit rates altogether. Only then will it truly be able to use market-based interest rates to manage the economy.

Nevertheless, after a long march of more than two decades, the PBoC is closer than ever to managing monetary policy in the same way as other major central banks. Still, whether managing monetary policy through interest rates will be as effective as it is in developed economies such as the US and Europe remains to be seen. The disjointed and still-evolving structure of China's economy means changes in interest rates are likely to have somewhat different and unique impacts on economic behavior and activity than in other jurisdictions. Given that reality, these ongoing changes to monetary policy practice and execution should be squarely on investors' radar – as they will impact China's future economic growth cycles in potentially surprising ways.