Guest post: don’t assume interest rate liberalisation will transform China’s economy

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The Chinese central bank has recently dropped hints that it will quicken the pace of interest rate liberalisation. This has raised hopes for everything from improving efficiency to reducing China’s “excessive” savings and current account surplus.

However, to improve efficiency, this reform alone is insufficient, and complementary reforms outside the central bank’s controls must be undertaken in concert. The hopes for a much reduced current account surplus from this reform are misplaced and will be dashed.

The current regime places a ceiling on the deposit interest rate but a floor on the lending rate. The biggest beneficiaries of this scheme are large state-controlled banks, since the gap between the two interest rates provides a fat profit margin. The biggest losers are savers who face an implicit tax and companies, especially private-sector groups, which face a higher cost of capital than necessary.

The reform will likely produce a lower (real) lending rate and a higher deposit rate. It appears logical to think that the reform should lead to a better allocation of resources. However, in the absence of further reforms on the state-owned enterprises (SOEs), the interest rate liberalisation could exacerbate rather than reduce inefficiency.

Specifically, SOEs often overinvest, because their senior management is rewarded for scale and size instead of just pursuit of profit. If the interest rate liberalisation reduces the cost of capital, their urge for scale could result in more overinvestment. This problem is aggravated by the fact that many SOEs do not pay a market price for using natural resources and do not pay the full social cost of compromising the environment.

In short, reforming SOEs and imposing adequate social costs of using environmental and natural resources are complementary reforms necessary for improving efficiency. One challenge is that these reforms are outside the purview of the central bank.

Let us now look at the implications of the reform for the current account. A popular theory in some Washington-based think tanks is that the current interest rate regime is the key culprit behind China’s high savings rate and current account surplus. The supposed logic is that the low real interest rate on bank deposits has caused people to raise their savings rate to compensate for the lost interest income. This has then led to a current account surplus. By this theory, this reform would reduce China's current account surplus.

This theory is false both logically and empirically. Logically, a lower interest rate produces two effects, with opposite signs. On the one hand, because the reward for savings is lower, people would save less. On the other hand, because interest income is lower, people feel poorer and may choose to consume less and save more. While the net effect appears ambiguous, both experimental evidence and statistical analysis of people's actual savings choices overwhelmingly suggest that the first effect dominates. This means that the Chinese now save a lot in spite of a low interest rate, not because of it. The interest rate reform per se may very well raise China's savings rate and current account surplus.

The Chinese current account surplus is not a mystery. Two factors are especially noteworthy. The first is China's accession to the World Trade Organization (WTO) in late 2001, which, by itself, tends to reduce the domestic return to capital, generating incentives for the country to park a greater portion of its wealth in foreign assets during a transitional period of about six to seven years. Research I conducted with Jiandong Ju and Kang Shi suggests that this has contributed one-third of the surplus we observed.

The second factor is a rising ratio of marrying-age young men to young women since 2002. This imbalance has caused young men, and especially their parents, to raise their savings rate in order to compete better in the marriage market. The same force has also contributed to a rise in the corporate savings because more parents with an unmarried son and more young men themselves have chosen to be entrepreneurs.

Given the difficulty in getting a bank loan, new entrepreneurs and small firms must rely on self-savings to finance their operation and expansion. Together with Xiaobo Zhang and Qingyuan Du, I estimate that this force has accounted for another one-third of the current account surplus.

Because the gradual reforms associated with the WTO accession have been completed, the part of the surplus due to this factor is naturally winding down. In contrast, because the sex ratio imbalance is going to rise over the next decade, the part of the surplus due to this factor is not going away any time soon. To be sure, other factors also matter, but not as much as commonly assumed.

In sum, while the interest rate reform may carry many benefits, reducing the country's current account surplus is not one of them.

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