

China International Finance Forum—October 2009

Why China Should Continue with Interest Rate Reform

Tarhan Feyzioglu
Resident Representative
International Monetary Fund

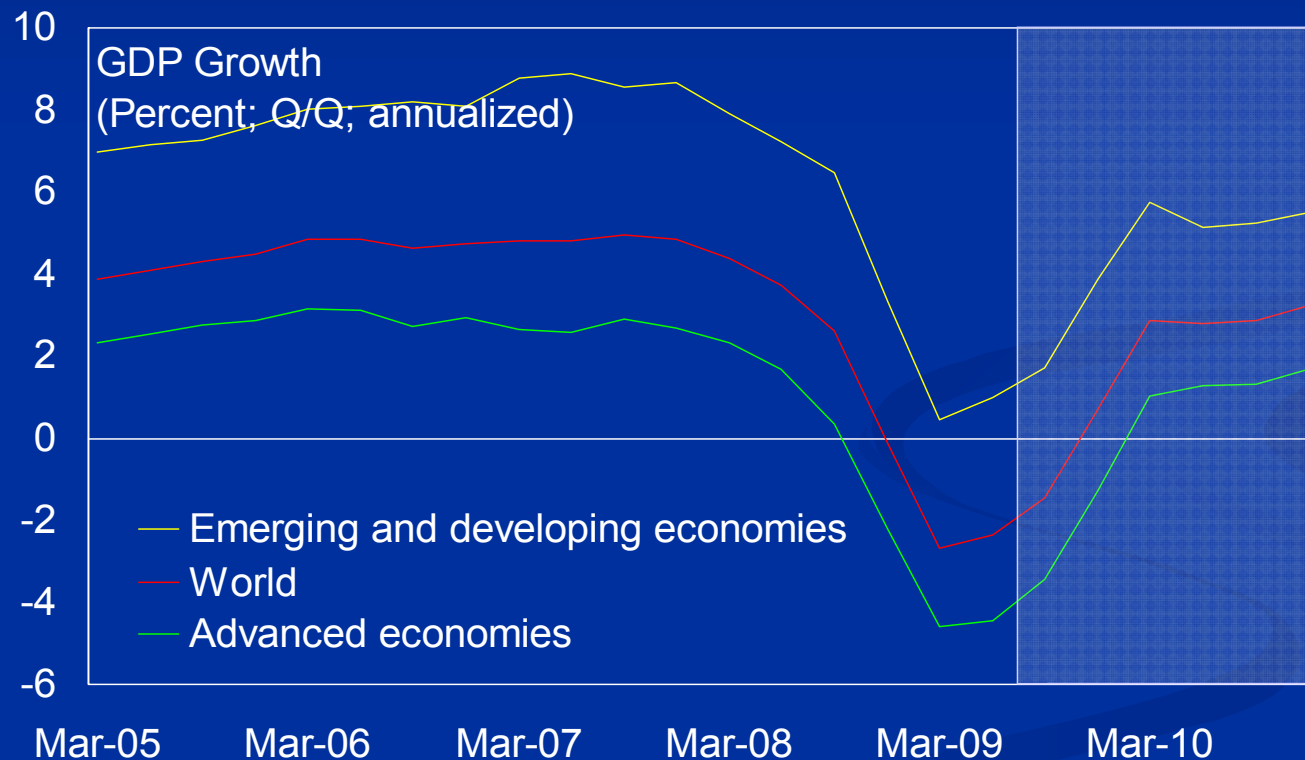


The views expressed in this presentation are those of the author and should not be attributed to the IMF, its Executive Board, or its management.

**China and the world are coming
out of the global financial crisis.**

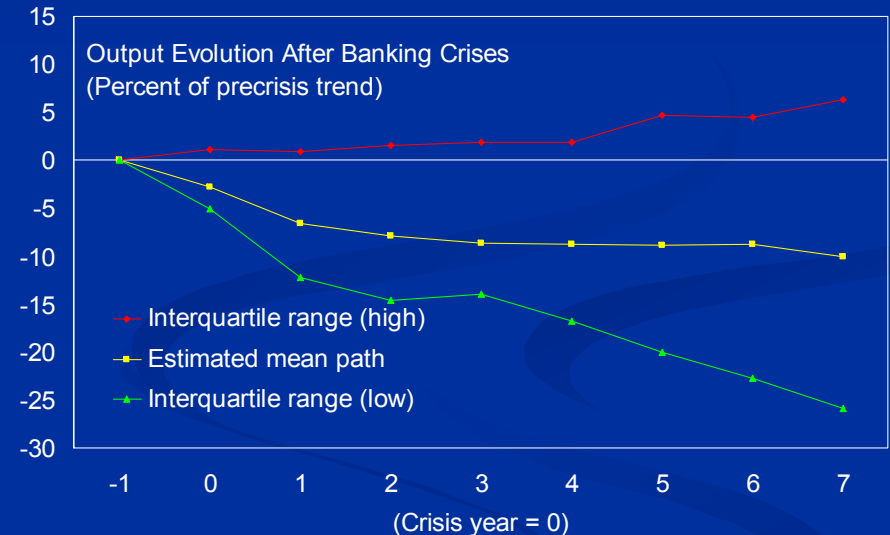


The global recession is ending, but recovery will likely be sluggish....



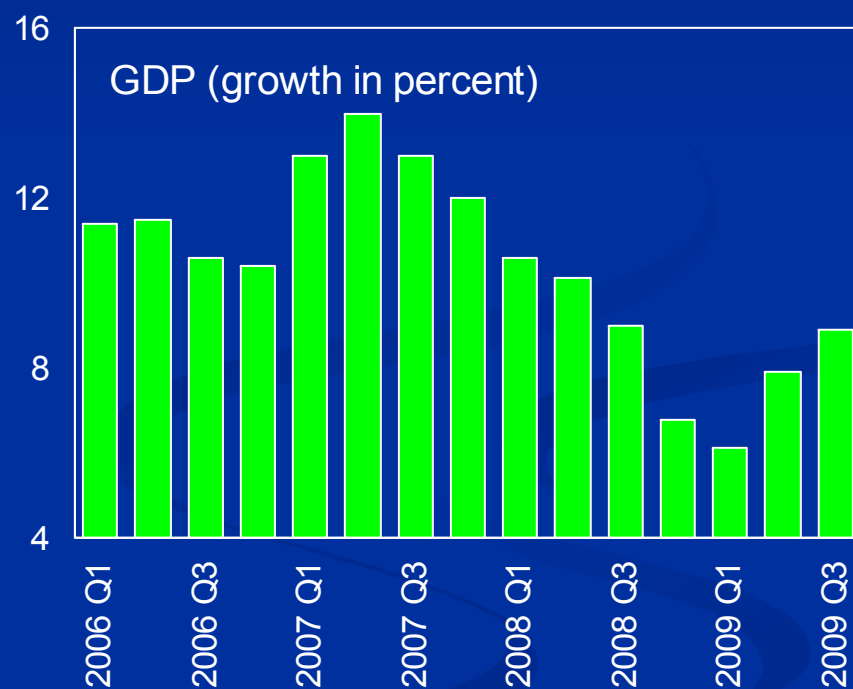
...because underlying private demand remains weak.

- The baton will eventually need to be passed from the public to the private sector.
- But, private demand is not strong in advanced economies.
 - Household saving rate has risen significantly in the U.S.
 - Unemployment rate is climbing.
- China will not be able to offset fully weaknesses in demand in the industrial countries.
- Historically, on average no rebound to pre-crisis trends after banking crises.



China is recovering remarkably fast.

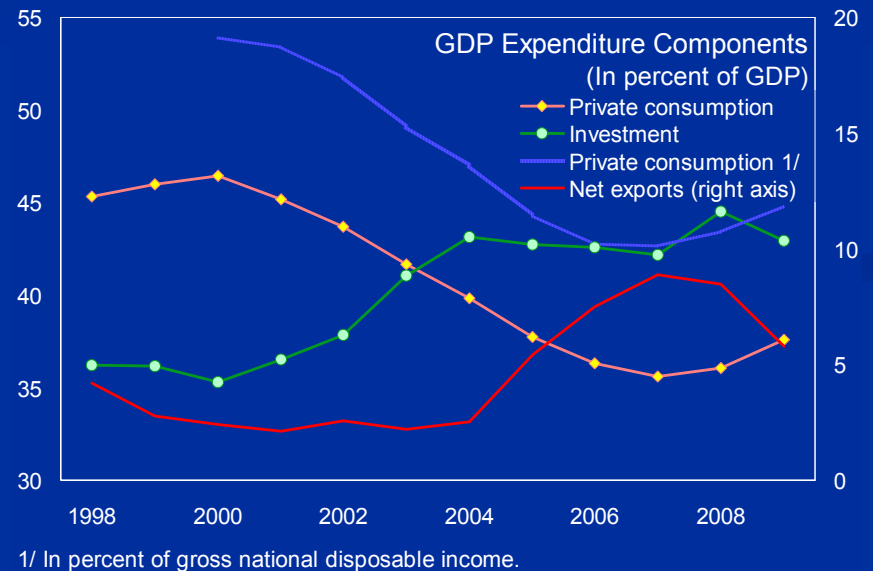
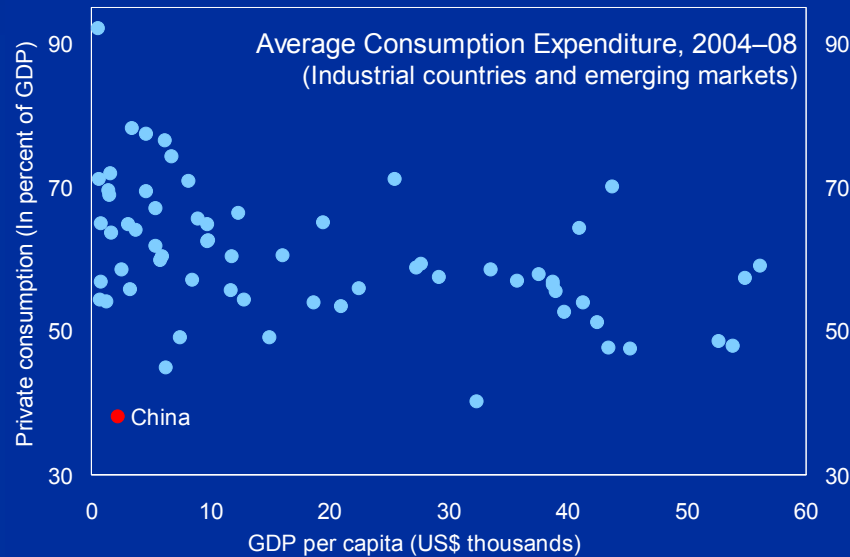
- The authorities acted early and decisively to counter the negative impact of the global financial crisis.
- There is growing evidence of a turnaround:
 - Strong investment growth, led by public projects.
 - Consumption held up well.
 - Industrial production is rebounding.
 - Business confidence is back on the optimistic side.
- Government policies remain accommodative.



**But, China is facing a critical
challenge:
reorienting the economy
away from exports and investment
toward consumption.**

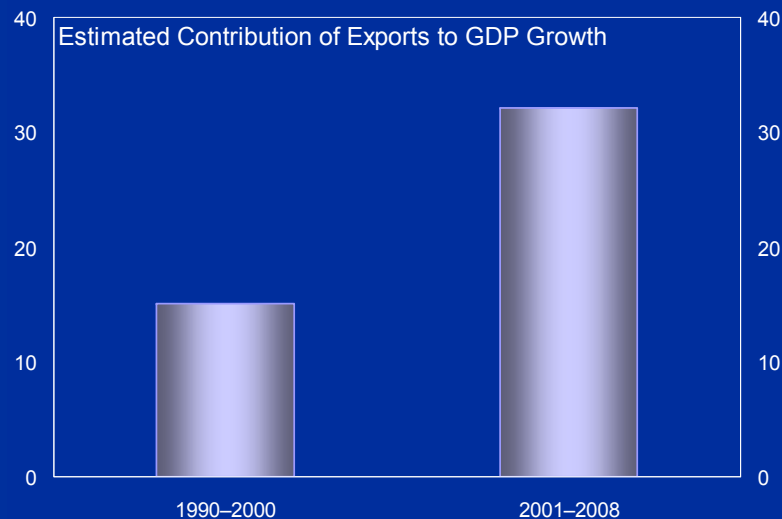


Consumption is too low.

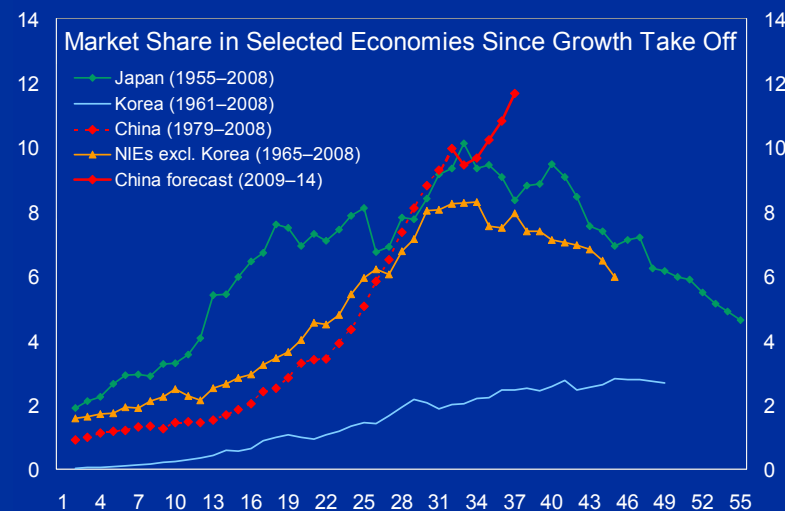


There are limits to export-oriented growth.

- Exports have played an increasing role in growth

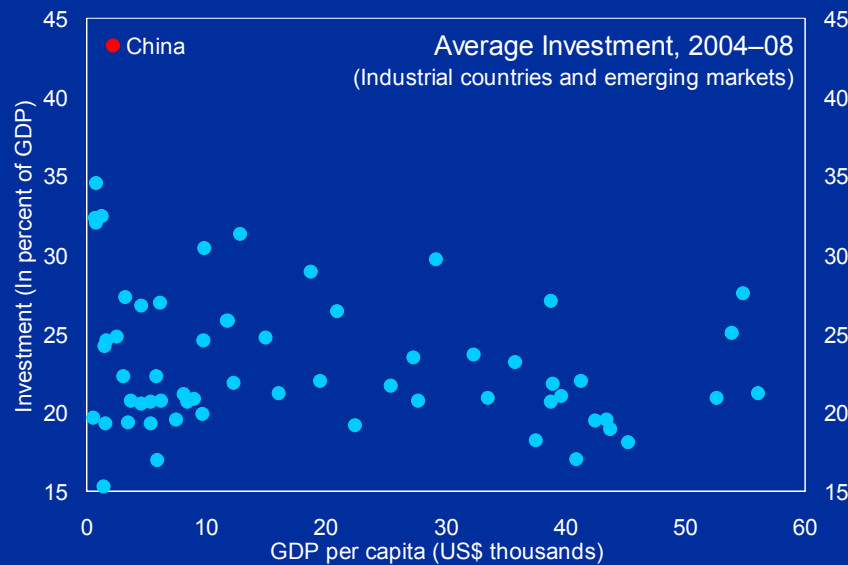


- Continuation requires big gains in market share

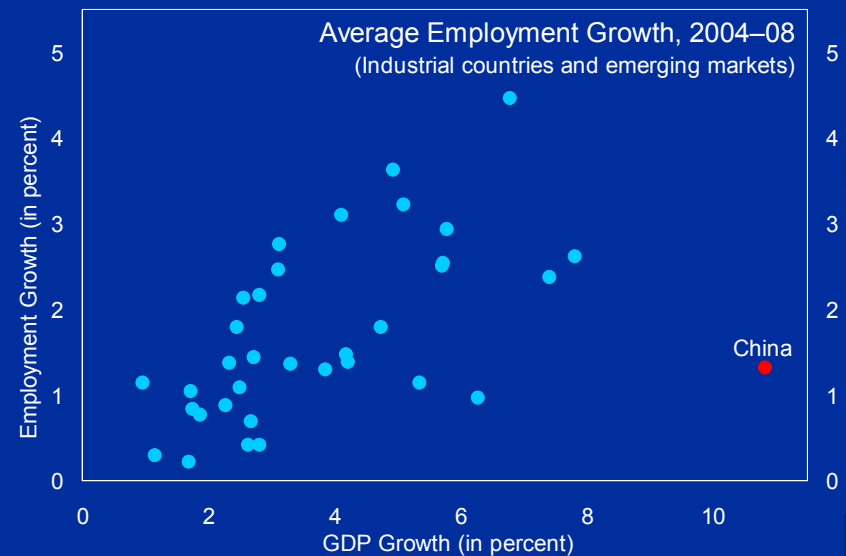


Investment should be reoriented toward domestic demand...

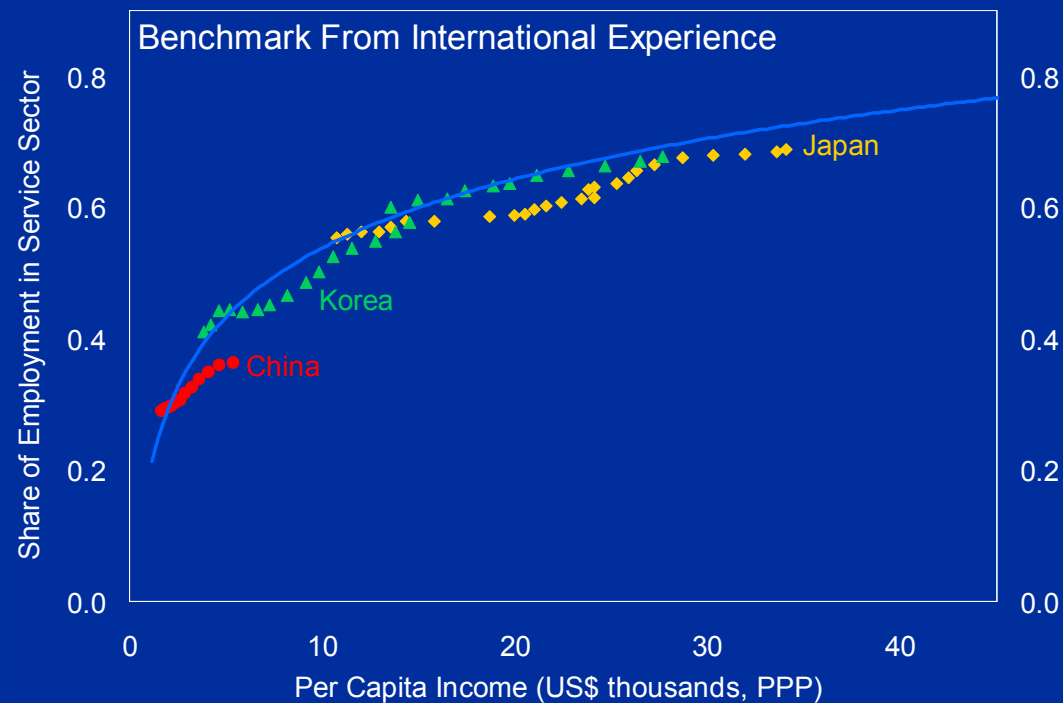
- Investment is high by international standards



- Growth has not been job intensive



... and in particular toward services, which will have positive implications on employment.



**A key constraint in
reorienting the economy:
interest rate controls.**



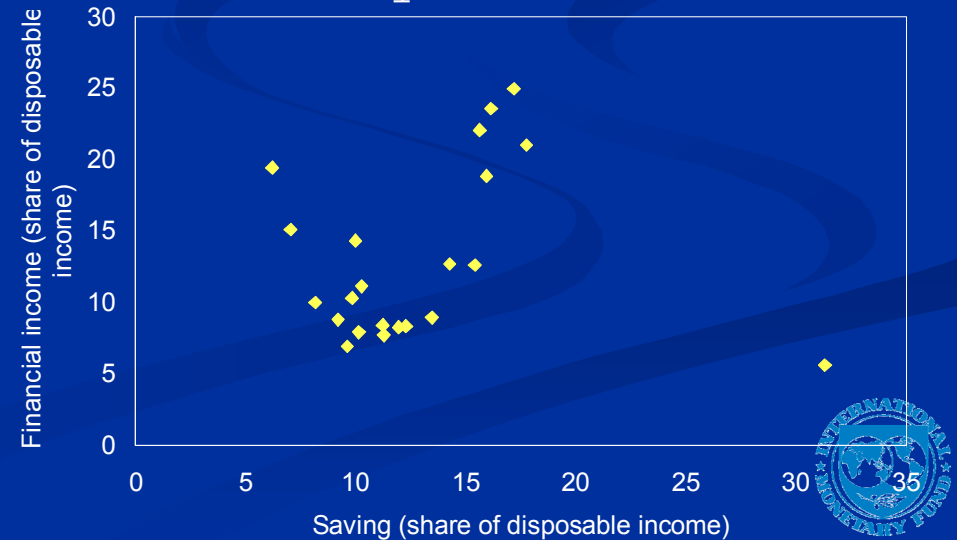
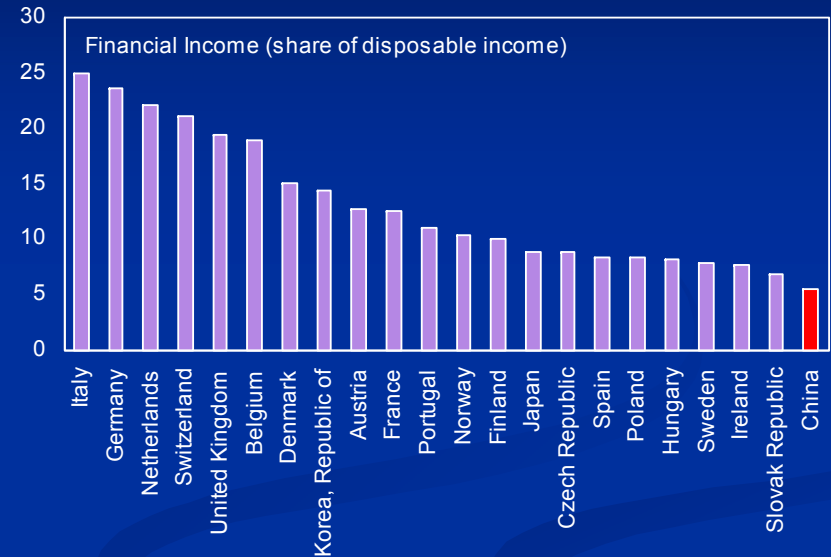
Interest rate controls

- Deposit rates are subject to a ceiling, lending rates are subject to a floor.
- Impact on consumption
- Impact on investment



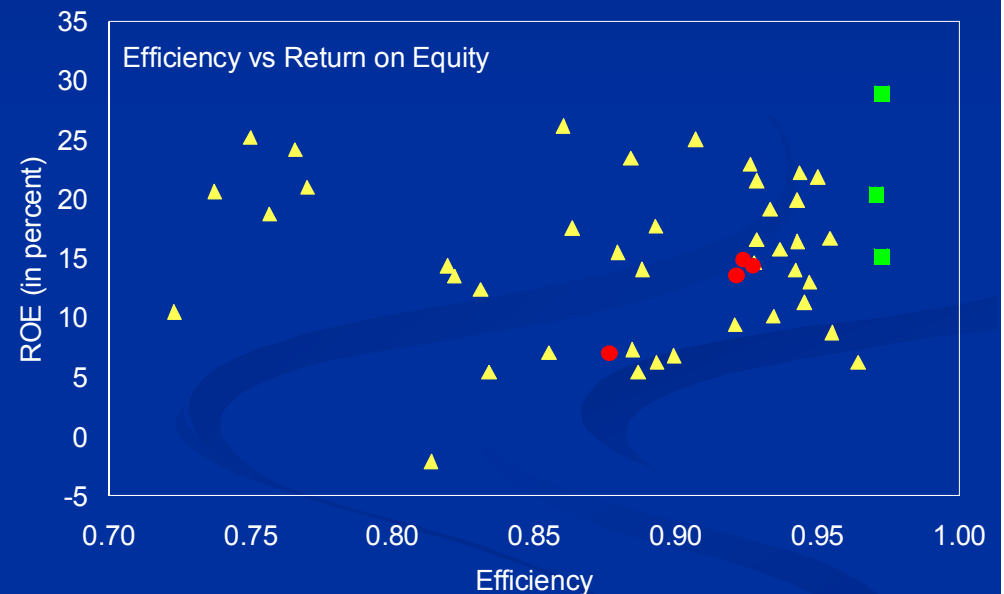
Deposit rate ceilings are limiting financial income, suppressing consumption.

- Shallow financial markets.
- Low return to savings because of the ceiling on deposit interest rates.



Interest rate controls are supporting an inefficient banking sector...

- Profitability is not correlated with efficiency.
- Large banks operate at diminishing returns to scale and small banks are too small.
- The system remains monopolistically competitive.



...contributing to imbalances.

- Banks lend to large firms and capital intensive projects, rather than SMEs, which create more jobs.
- Low lending rates lead to inefficient investment and excess capacity.



A win win win situation if interest rates are liberalized:

- Banks become more efficient (simulation confirm).
- The economy's resources are channeled better.
- Households get better return on their savings (simulations confirm) and consume more.
- International experience with interest rate liberalization:
 - Higher real interest rates.
 - Surplus shifting from borrowers to savers.
 - Better access to credit of those who were previously crowded out.
 - Greater bank competition and efficiency gains.



But, there is a risk: financial instability.

- Excess bank competition
- Excess lending
- International experience:
 - Several cases where financial crisis followed interest rate liberalization.
 - Looking closely, the reason was not liberalization but lack of appropriate monetary policy and adequate supervisory oversight.



Macro and prudential measures should be taken to avoid such risks.

- Bank regulation and supervision: prevent banks entering too risky businesses.
- Monetary policy: prevent excess demand.
- Timing and sequencing: when the economy is not overheating and the capital account is not opened simultaneously.
- Policy tools: deepen money markets.



Detailed information:

www.imf.org

www.imf.org/Beijing



Thank you.

