Views on marketization reform direction of China's interest rate and exchange rate

You Chaozhong  
School of Public Administration  
South West Jiaotong University  
Cheng, China  
E-mail: youchaozhong@126.com

Abstract—Economic reform is the core of deepening the reform of our country nowadays, and this paper will focus on the marketization reform direction of China's interest rate and exchange rate. This paper starts from domestic and international economic environment, facing the marketization reform of China's interest rate and exchange rate. Then it elucidates three drawbacks, which are the existing foreign exchange market instability, the market-oriented reform of interest rate unbalance and the slow market-oriented reform of interest rates respectively. The article follows by analyzing the marketization reform direction of China’s interest rate and exchange rate by synthesis at three aspects, which are the selection of path to the market-based reform of interest rate and exchange rate, marketization reform and gradual reform which is in favor of the interest rate and exchange rate marketization development. In the future, China should always go ahead in the direction of marketization reform unswervingly.

Keywords—the reform of the economic system; the marketization of interest rate; the marketization of exchange rate; gradual reform

I. INTRODUCTION

The Third Plenary Session of the eighteenth Communist Party of China puts forward that our present tasks are to deepen the reform of the economic system, to improve the basic economic system and to speed up the improvement of modern market system, open economic system and macroeconomic regulation and control system. In a word, what we focus on is to make the market play a decisive role in the allocation of resources and also to deal with the relationship between government and market. Nowadays the marketization reform of interest rate and exchange rate is the key project of our country among the financial system reforms.

In recent years, the RMB exchange rate against the U.S. dollar maintains a continuous rising trend. Since 2007 the global economic has been in turmoil, because the international role of the dollar suffered severe impact by the outbreak of US Sub-prime loan Crisis. But the global financial crisis triggered by US Sub-prime loan Crisis continued to spread in 2008 and the outbreak of European Debt Crisis at the end of 2009 led the financial position of Euro, Sterling and other major currencies to encounter hitherto unknown attacks. Thus, the dollar, as the asset to avoid risks, began to pick up and developed slowly, favored by the international market. And the RMB exchange rate against the U.S. dollar remained relatively stable [1-2]. At the same time, in order to deal with the impact of Global Financial Crisis and European Debt Crisis to our country’s economic development and to implement the financial system reform, People’s Bank of China used the method of adjusting interest rate to regulate and control domestic market for enlarging domestic demand and investment.

At present, our country’s interest rate market, whose stage goal is that “the deposit interest rate controlling the upper limit, while the loan interest rate controlling the lower limit”, has gained some achievement in promoting social fairness and justice and improving people’s well-being [3].

II. REASONS FOR THE MARKETIZATION REFORM OF CHINA’S INTEREST RATE AND EXCHANGE RATE

A. The instability of foreign exchange market

Since the outbreak of Global Financial Crisis, People’s Bank of China has suppressed the interest rate to make the RMB exchange rate stable and to avoid the risk of financial crisis, which made the interest rate at a low level for a long time. If our country further speeds up the reform of interest rate marketization, the cost for making foreign exchange market stable could rise, while our country could be forced to buy a large number of foreign exchange. Thus it would make resources go waste, and also increase the money supply in domestic market, which may trigger hyperinflation. For the past of few years, the overall situation of our foreign exchange reserves can be seen in Table I.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>105.0</td>
<td>139.8</td>
<td>144.9</td>
<td>154.6</td>
<td>165.5</td>
<td>212.1</td>
<td>286.4</td>
<td>403.2</td>
</tr>
<tr>
<td></td>
<td>49</td>
<td>9</td>
<td>59</td>
<td>75</td>
<td>74</td>
<td>65</td>
<td>07</td>
<td>51</td>
</tr>
<tr>
<td>2004</td>
<td>609.9</td>
<td>818.8</td>
<td>1066.</td>
<td>1528.</td>
<td>1946.</td>
<td>2399.</td>
<td>2847.</td>
<td>3181.</td>
</tr>
<tr>
<td>2005</td>
<td>32</td>
<td>72</td>
<td>34</td>
<td>249</td>
<td>03</td>
<td>152</td>
<td>338</td>
<td>148</td>
</tr>
<tr>
<td>2006</td>
<td>2845.</td>
<td>2121.</td>
<td>2864.</td>
<td>403.2</td>
<td>49</td>
<td>9</td>
<td>59</td>
<td>75</td>
</tr>
<tr>
<td>2007</td>
<td>609.9</td>
<td>818.8</td>
<td>1066.</td>
<td>1528.</td>
<td>1946.</td>
<td>2399.</td>
<td>2847.</td>
<td>3181.</td>
</tr>
</tbody>
</table>
B. Imbalance of the development of interest rate marketization

1) From the market perspective

Now China’s loan interest rate of commercial banks has basically achieved marketization, while there deposit interest rate has been controlled strictly. Because the loan interest rate will rise once the deposit interest rate is in liberalization, which would cause an increase to the cost of capital. What’s more, the debt of China’s companies or profit organizations is equal to 100% of GDP in 2012. So the increase of interest rate may cause damages to the interests of China’s companies or profit organizations which would hit investment enthusiasm. China’s middle and small-sized enterprises develop very quickly, and there are none formal channels of financing in these enterprises because of the lack of personnel quality, management and enterprise system, and commercial banks are reluctant to lend loans to them. Therefore, the key to make interest rate market have a coordinated development is to require reasonable reform of interest rate and flexible use of interest rate policies to regulate financial markets.

2) From the region perspective

As far as we know, China’s vast territory and large population and unbalanced economic development result in the imbalance of regional economic development. Because regional economic development and market economic system can influence the development of China’s interest rate marketization, the financial system of the coastal areas now is more perfect than inland underdeveloped regions, and it operates better. The marketization of interest rate, also, develops more quickly than inland underdeveloped regions. However, various resources at home and abroad gathered in the coastal developed areas are owing to the trend of economic market development, which would cause imbalance to the China’s interest rate development.

C. The marketization reform of interest rate has been slow

In the pre-process of China’s market-oriented interest rate reform, incremental reform, as a kind of supply for dominated institutional change, has played an important role in starting the market-oriented reform, which depends on lower friction cost. However, due to the inherent regulation of this kind of institutional change mode, there must be a series of insurmountable obstacles. Therefore, there also must be slowness and tortuosity existing in the marketization of China’s interest rate all the time.

1) Economic reform paths make deposit rates low for a long time

The path to China’s economic reform starts from the state-owned enterprises to state-owned banks, so that the banks bear most of the cost of state-owned enterprise reform and face large risks. Therefore, there must be a kind of situation with lower interest rate to maintain lower cost during the reform process of state-owned enterprises and state-owned banks. Also, this explains that the interest rates benefit for banks, such as inter-bank market interest rates and loan interest rates, have basically achieved marketization, while the deposit interest rate has not achieved marketization, but in a low level.

2) The mode of China’s economic growth has relied on investment

As we know, the aggregate investment accounting for the proportion of GDP reached 54.8% in 2010, and also reached 54.2% in 2011. The reason is that low interest rates are beneficial to reduce the cost of investment and then the rate of investment return would increase, which results in further increase of the rate of market investment. China’s investment is so major that state-owned banks loan to local government and state-owned enterprises. And most of them which belong to the projects for the infrastructure construction and industrial park construction have long cycle and their earnings reflect the public welfare, so that the investment can only bear the benchmark interest rate over the same. If the loan interest rate increases sharply, these loans would be stopped, which makes the projects in the construction to be forced to stop, eventually forming bad debts. Once the interest rate market is in liberalization, the low-cost investment would be difficult to achieve. What can be seen, from this aspect, is that the low interest rate environment in domestic, to a certain extent, is determined by the mode of China’s development.

3) Tortuosity exists in the development of China’s interest rate marketization

Firstly, there are fundamental obstacles existing in the established China’s market interest rate system. The normative market behavior of China’s economic subject has not yet been established, and financial transactions subject has no ability to make a rational option for pricing conformed to market rules when facing market-oriented interest rate and to resist the risk of interest rate. In terms of financial organizations, the barriers promoting China’s interest rate marketization is mainly attributed to that the governance structure of banking and the modern enterprise system are not perfect, to the institutional defects that property right to commercial bank is not clear, to the monopoly on financial industry, to the potential risk restraint of banking and so on. However, in terms of non-financial enterprises and individuals, the reason why the bottleneck of reform survives is that the budget of enterprises reform is qualified and that interest rate lacks of elasticity.

Secondly, there is some tortuosity existing in the behaviors of China’s commercial bank. In terms of government providing public goods and the supply system on the market, the policy to pay interests on reserves formulated by the monetary authorities reduces the operating space to the central bank interest rate policy and distorts the behavior of commercial banks.

In addition, the monetary policy framework regarding the money supply as the intermediate target, could restrain the

---


progress of interest rate marketization formation. Because of the central bank’s lack of independence and aloofness, non-indirect to macro-control means and defects of three indirect regulation mechanisms, the effects of macroeconomic regulation and control to interest rate marketization would be influenced, resulting in many unfavorable situations as the analysis of the above [7].

III. THE MARKETIZATION REFORM DIRECTION OF CHINA’S INTEREST RATE AND EXCHANGE RATE EASE OF USE

A. The path choice for interest rate marketization reform

In 2003, the People’s Bank of China released a document named Report on the implementation of Chinese monetary policy in 2002, pointing out that the basic framework of China’s interest rate and exchange rate is that “local currency after foreign currency, loan after deposit, small loan after large loan, short-term loan after long-term loan”. At the same time, adding the private banks could enrich the banking system, which made banks under full and healthy competition, and avoid financial monopoly, which let all the people enjoy the achievement of bank system development much fairly.

Firstly, deposit and loan market and bond market should be used rationally to determine China’s interest rate. Macroeconomic theories point out that interest rate is determined by deposit and loan market and bond market. At present, the domestic deposit and loan market has some defects, poor liquidity and information asymmetry. In consequence, China’s commercial banks still profit from the interest differential between deposits and loans. However, these defects don’t survive in bond market, and rate of return could reflect both the supply and demand of funds and risk preference effectively, thus, China’s interest rate marketization reform could be promoted from bond market [8].

Secondly, the development of China’s commercial bank industry should be coordinated and promoted availably. The current situation of China’s deposit and loan interest rate is that loan rate is still high, while in deposit rate is low, which made black market lending spread and banking functions weak in social investment and financing. Maybe, risk premium would be heated up, then rustling in moral risks. Therefore, the reform direction of interest rate marketization is that loan rates could focus on relaxing the deposit rates. This could not only ensure effective savings, but also assure that banks have profit, so that the status and enthusiasm of China’s commercial banks would be improved in capital market. Even, bankruptcy mechanism could be built to make financial markets develop more effectively, and also negative list management mode should be used to arouse the enthusiasm of banks, companies and individuals adequately in financial market.

Thirdly, China’s interest rate market should be planned reasonably and long-term objectives should be formulated rationally. China’s market economy tends to be short line operation, but ignores potential projects having long-term interests. Meanwhile, short-term loans are overvalued in banking market, while long-term loans are undervalued because of uncontrolability in long-term projects, which distorts interest rate market. Thus, the scheme, “short-term after long-term”, could be implemented so that banks, out of avoiding loan risk, prefer short-term loans, which would cause interest rate term of enterprises mismatch(long-term interest rates is lower than the short-term one)[9].

In a word, the government should build a market system, not unified and open, but also competitive and orderly step by step, and should speed up the formation of modern market system, including enterprises’ independent operation and fair completion, consumers’ freedom of choice and autonomous consumption and goods and factor free mobility and equal exchange, and should strive to clear market barriers and to improve the efficiency of resource allocation and fairness.

B. The path choice for exchange rate marketization reform

According to macro-economic theories, exchange rate policy, as a kind of monetary means, is mainly used to regulate and control foreign exchange market. At present, China’s foreign exchange market is instable and has lots of foreign exchange reserves. So some measures should be carried out to ensure that China doesn’t suffer economic loss due to the appreciation of RMB.

Firstly, to create a precondition for RMB exchange rate marketization reform, the reform of property right should be carried out. The main reason why China’s exchange rate marketization developed slowly is that the supply and demand of China’s foreign exchange market don’t have independent property right. Property right bodies are banks or enterprises or individuals that can engage in economic activities in accordance with both their own wishes and the law and obtain exchange gain, and that must undertake some risk and loss matching with earnings. In foreign exchange market, property right bodies must be relying on the criterion, which is to minimize the loss in exchange for the greatest benefit, to engage in economic activities, and then self-motivation and self-restraint mechanism could be formed. Thus, according to the principle of safeguarding people’s interests, property right should be reformed and be defined completely and also be given equal protection. This could ensure stable development of foreign exchange market and effectively promote the marketization reform of exchange rate [10].

Secondly, a good exchange stabilization fund system should be established. Because of imbalance in China’s foreign exchange market development and foreign exchange reserves, a rational exchange stabilization fund system needs to be built to guide the People’s Bank of China reasonable currency, so that the passive situation caused by the increase of foreign exchange reserves would not occur. We should adhere to the principle of allowing unlimited entry at the absence of threshold requirement and absorb a variety of foreign currency and make the floating risk of exchange rate the lowest. Meanwhile, under the premise of retaining the existing spot trading tools, the Central Bank should increase foreign exchange regulation tools and could add some methods, such as swap and forward transaction. Not only can it enhance intervention initiative and flexibility of the Central
Bank, but also it can reduce the difficulty and transaction cost of intervention.

C. The marketization reform of interest rate and exchange rate should be taken progressive mode

Firstly, China’s special national conditions determine that reforms should be gradual. At present, China’s interest rate market and foreign exchange market develop distorted and slowly, and the domestic economic environment is affected by international new economic situation, so the subjects of interest rate or exchange rate market become obscure, which would reduce the impact of reform results. Reform does not accomplish at one stroke, and the situation of China’s economic is that the east is strong and full of resources, but the west is not. In a word, the gradual reform of interest rate and exchange rate marketization matches with China’s basic national conditions.

Secondly, China’s economic structure determines that the reform should be gradual. China’s economy is that there are some obvious gaps between city and countryside, called the two element structure. And promoting the development of new types of urbanization in China causes that lots of people flow into the city and the emergence of the urban-rural fringe zone also hinders the regulation of suburban areas and economic operation. Because of these questions, the marketization reform of interest rate and exchange rate in these backward regions should be in gradual operation under the situation of social harmony and justice.

Thirdly, the transformation of China’s government determines that the reform should be gradual. In the process of marketization reform of interest rate and exchange rate, there are some higher requirements to central government and local government, such as flexibility, perspectiveness, the capacity of regulating financial order and so on. The governments also would spend much time to improve themselves, to enhance public credibility and implementation capacity and to construct law-based and service-oriented government. Therefore, we should give the government some time to build the new regulation system for new economic development, and then China’s marketization reform of interest rate and exchange rate will to win [11].

IV. CONCLUSION

Our country should gain more confidence and get much strong positive energy force together to push forward the reform with properly handling the relationship of reform, development and stability. At the same time, China should stick to the principle, that is, to combine the top-level design with looking before leaping, and then improve the scientficity of reform decision to form the ability of reform. Therefore, during the process of the marketization reform of China’s interest rate and exchange rate, our country should always hold flag issue on interest rate and exchange rate marketization, namely reform direction, and should recognize the international and domestic economic situation so as to develop the domestic financial market.

In the meantime, our country should formulate the development path suitable for the marketization reform of China’s interest rate and exchange rate, with reference to international experience of financial management and control. We should also increase the regulation tools of the financial market, and promote the marketization reform of interest rate and exchange rate gradually, so as to maintain the domestic economy stable.

REFERENCES