DATE: July 24, 2017

MEMORANDUM TO: File

FROM: John Corrigan
International Trade Compliance Analyst
AD/CVD Operations, Office VI

RE: Countervailing Duty Investigation of Certain Aluminum Foil from the People’s Republic of China

SUBJECT: Review of China’s Financial System Memorandum

The Department of Commerce (the Department) is placing the following documents on the record of this investigation:


Attachment 2: Documents cited in Attachment 1.

In accordance with 19 CFR 351.301(c)(4), the Department is providing an opportunity for interested parties to comment on the information contained in this memorandum. Comments should be submitted, using ACCESS electronic filing system, no later than 5 p.m. Eastern Time, on July 31, 2017.
DATE: July 21, 2017

MEMORANDUM FOR: Gary Taverman
Deputy Assistant Secretary
for Antidumping and Countervailing Duty Operations,
performing the non-exclusive functions and duties of the
Assistant Secretary for Enforcement and Compliance

THROUGH: P. Lee Smith
Deputy Assistant Secretary
for Policy and Negotiations

James Maeder
Senior Director;
performing the duties of the Deputy Assistant Secretary
for AD/CVD Operations

Robert Heilferty
Acting Chief Counsel
for Trade Enforcement and Compliance

Michael Rollin
Acting Director, Office of Policy

Albert Hsu
Senior Economist, Office of Policy

FROM: Leah Wils-Owens
Timothy Hruby
Office of Policy, Enforcement and Compliance

SUBJECT: Review of China’s Financial System for Countervailing
Duty (CVD) Benchmarking Purposes
EXECUTIVE SUMMARY

On the basis of an analysis of China’s current financial sector, including the formal banking sector, the interbank market, the bond market, and “shadow banking,” the Department of Commerce (the Department) has determined that distortions of the system preclude the use of interest rates within China for CVD loan benchmarking and discount rate purposes. In particular, even though the government nominally removed the last remaining control on lending and deposit rates at the end of 2015, soft budget constraints, non-arm’s-length pricing, and government policy directives fundamentally distort the market from both a risk pricing and a resource allocation standpoint. In addition, an analysis of interest rate dynamics suggests that interest rates are not yet market-determined.

We found these distortions to be directly tied to state ownership and control1 and to the state’s pervasive and intrusive role in China’s financial system. While state ownership, *per se*, does not necessarily mean that interest rates are fundamentally distorted or not market-determined, the state’s role in the market in China extends far beyond just state ownership. The state’s explicitly stated goal is to preserve a leading role for the state sector in China’s economy, in general, and in the financial sector, in particular. The state views state-owned banks, at both the central and local government levels, as important government policy instruments, much as it sees state-owned enterprises as instruments (and objects) of state industrial policy. As the government of the People’s Republic of China (PRC, or China) itself recognizes, full nominal interest rate liberalization was a big, important step, but only one step, along the path to market-determined interest rates. Old habits and long-established lending practices die hard, particularly in the face of mixed signals from the government about the respective roles of the government and the market in China’s financial system.

In China’s still bank-dominated financial system, the state (at the central and local government levels) maintains and exercises effective control over the vast bulk of banking sector assets. Moreover, the state has not resolved the inherent conflicts in an economic strategy wherein (a) the state continues to use banks as government policy instruments to pursue industrial policy and social welfare goals, and, at the same time, (b) the state seeks to give the market a decisive role in resource allocations. It almost certainly cannot do both, but appears unable at this time to choose between the two. Therefore, China’s financial sector remains fundamentally distorted such that interest rates within China cannot be used for CVD loan benchmarking and discount rate purposes.

1 INTRODUCTION

The Department last completed a full assessment for trade remedy purposes of China’s financial sector in the 2006 antidumping investigation of lined paper from China, in the context of reviewing China’s non-market economy country status.2 In 2007, in the Final Determination of

1 “State,” for purposes of this paper, refers to any level of government, as well as the Chinese Communist Party.

the CVD investigation of coated free sheet paper from China, the Department elaborated on the implications of that assessment for CVD proceedings, explaining that because interest rates in China were not yet market-determined, none could be used for CVD loan rate benchmarking purposes.  

In the 2006 assessment, the Department found a significant state role in the banking sector, particularly through the high degree of state-ownership or control (at the central and local levels), the lack of policy independence of the People’s Bank of China (PBoC) from the state (i.e., the PBoC operated under the guidance of the State Council and submitted major decisions for approval), tight regulation of both retail deposit and lending interest rates, and the minimum mark-up on all renminbi (RMB) loans that those interest rate controls produced for banks. The state’s role in the banking sector at the time, both direct and indirect, distorted the market to such an extent that it precluded a finding of market-determined interest rates in China.

At the time of the 2006 assessment, China’s financial sector was bank-dominated, and interbank and bond markets were underdeveloped to the point where the Department determined it sufficient for purposes of its analysis to focus exclusively on the formal banking sector and bank lending and deposit rates. However, for purposes of this 2017 assessment of China’s financial sector, the Department has expanded the scope of its analysis to include the interbank market, the bond market and “shadow banking,” as well as corresponding interest rates and yields. The Department finds this to be appropriate given the more recent growth and development of the market and financing channels outside the formal banking sector, as well as the increase in market complexity and inter-market connectedness.

China’s large and growing financial sector reflects China’s large and growing economy. China’s real GDP increased at an average annual rate of 9.6% between 2006 and 2015, when it reached a level of $11 trillion, second in the world only to the U.S. GDP of $18 trillion. Total Social Financing (TSF) in China – a PRC government measure of financing to the household and corporate sectors (including local government financing vehicles) – increased from 157.9% of GDP in 2011 to 198.4% of GDP in 2015. However, the PRC government’s TSF estimates

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ignore a potentially large amount of shadow bank financing, which has grown rapidly in recent years.\textsuperscript{7}

Since 2006, the government has progressively relaxed interest rate controls to facilitate further development of the market’s role in China’s economy. In July 2013, the PBoC removed the floor on retail bank lending rates, and in October 2015, the PBoC removed the cap on retail bank deposit rates.\textsuperscript{8} As a result of these administrative actions, bank lending and deposit interest rates are now nominally free of direct government control.

In the following sections of this paper, the Department analyzes current structural, operational and institutional features of China’s financial system and their implications to assess whether interest rates in China can now be considered market-determined for CVD benchmarking purposes.

\section*{2 FORMAL BANKING SECTOR}

The banking sector in China is the largest in the world, with RMB 199.3 trillion ($30 trillion) in assets, equivalent to 40\% of global GDP.\textsuperscript{9} China’s four largest banks are also the world’s four largest.\textsuperscript{10} Although other types of financial institutions are emerging, China’s financial sector remains bank-dominated. Bank loans in the first quarter of 2016 were 142\% of GDP, compared to 79\% for “shadow banking” loans, 23\% for net corporate bond financing, and 7\% for non-financial enterprise equity.\textsuperscript{11}

The “Big Five” commercial banks in China – Bank of China (BoC), Industrial and Commercial Bank of China (ICBC), China Construction Bank Corporation (CCBC), Agriculture Bank of China (ABC), and Bank of Communications (BCM) – all operate large branch networks on a nationwide basis. These are truly large banks, with combined assets of over RMB 78 trillion in 2015. There are also 12 shareholding banks, known as joint-stock banks (JSBs), that also operate on a nationwide basis and had combined assets of over RMB 37 trillion in 2015. There are roughly 145 city commercial banks and credit unions that serve local markets and had combined assets of about RMB 24 trillion in 2015. Rural small- and medium-sized financial institutions, which collectively number in the thousands, and the postal savings bank together had combined assets of about RMB 28 trillion in 2015. There are also three specialized policy banks –

\textsuperscript{7} “Resolving China’s Corporate Debt Problem,” \textit{International Monetary Fund}, WP/16/203, October 2016, p. 4.
\textsuperscript{10} “Big but Brittle,” \textit{The Economist}, May 7, 2016.
\textsuperscript{11} “People’s Republic of China: 2016 Article IV Consultation – Press Release; Staff Report; and Statement by the Executive Director for the People’s Republic of China,” \textit{International Monetary Fund}, IMF Country Report No. 16/270, August 2016, p. 42. \textit{See also} “Quarterly China Shadow Banking Monitor,” \textit{Moody’s Investors Service}, April 2016, p. 6 for figure on shadow banking. This figure is from end-2015, but is considered more accurate than IMF (Article IV) figures of shadow banking, as these do not account for off-balance sheet shadow banking. \textit{See} section on shadow banking for further details.
Shenzhen Development Bank (SDB), Agricultural Development Bank of China (ADBC) and the Export-Import (EXIM) Bank— with an operational focus on infrastructure projects and pillar industries, agricultural goods procurement and rural development projects, and the expansion of external (foreign) trade, respectively. These three policy banks had combined assets of about RMB 20 trillion in 2015. Foreign-owned banks and bank branches also operate in China and had combined assets of RMB 4 trillion in 2015.12

Since 2006, the market share of JSBs and city commercial banks has grown considerably, perhaps 10-12 percentage points, at the expense of the largest banks. The combined market share of rural banks and credit cooperatives, village and township banks, and the postal savings bank has since 2006 also inched up 3-4 percentage points, apparently also at the expense of the largest banks. Foreign banks’ market share, at 2%, has remained unchanged over that period.13

2.1 Institutional Features

The fundamental distinguishing feature of China’s financial sector is the high level of state-ownership and control that exists to this day.14 Even after years of restructuring and divestiture, China’s largest five banks, which collectively accounted for approximately 40% of total banking sector assets in 2015,15 all remain majority state-owned.16 The JSBs, which collectively accounted for about 19% of total banking sector assets in 2015,17 operate for the most part with generally lower levels of direct state (often local government) ownership and are in some cases owned by state-owned enterprises (SOEs). City commercial banks and credit unions collectively accounted for approximately 12% of total banking sector assets in 2015, and there is significant private shareholding in these banks even though many remain under local or provincial government control.18 China’s small rural banks and credit cooperatives, and village and township banks, which are largely under private control, and the postal savings bank, which is


15 “2016 Q3 China’s Banking Sector: Performance of Listed Banks and Hot Topics,” KPMG, December 2016, p. 88. See also “BRIEF – China Bank Sector’s Total Assets Reach $29.8 Trillion - Regulator,” Reuters, September 26, 2016.


18 Ibid.
state-controlled, collectively accounted for approximately 14% of total banking sector assets. Foreign-owned banks and bank branches accounted for approximately 2% of total banking sector assets, and the wholly state-owned policy banks accounted for approximately 10% of total banking sector assets.\textsuperscript{19} Thus, although banking sector reforms and ownership diversification have resulted in significant private shareholdings in the case of some individual banks and certain segments of the market, effective state control over banking sector assets remains dominant and private control remains limited. Perhaps for this reason, as well as to promote market competition, the government under a pilot program has recently licensed several new private, internet-based banks that have targeted new and underserved markets. But they remain small, due in large part to difficulties in raising deposits.\textsuperscript{20}

In China, government influence over banking decisions is greater than in other countries.\textsuperscript{21} State-owned banks, including the PBoC, have never been truly separate from the Chinese Communist Party (CCP), the sole governing party of China. The CCP’s control still extends as far as influencing decisions about financial activity, including where to direct large loans.\textsuperscript{22} In addition, there exists a department within the CCP, the Organization Department, which is responsible for controlling staffing positions throughout China, including appointing executive officials in state-owned banks and financial institutions.\textsuperscript{23} According to the Brookings Institution, “[u]nlike in the West, the careers of the most important bankers are determined by the Party.”\textsuperscript{24}

China’s Commercial Banking Law states that “commercial banks shall conduct their business of lending in accordance with the needs of the national economic and social development and under the guidance of the industrial policies of the State.”\textsuperscript{25} In addition, the State Council and the National Development and Reform Commission published a “Catalogue for Guiding Industrial Restructuring” in 2005, most recently updated in 2011, along with implementation documents, that are intended to be “an important basis for guiding investment directions” and “to formulate and enforce policies on…credit.”\textsuperscript{26} The catalogue lists objectives for industrial restructuring

\textsuperscript{19} Ibid.


\textsuperscript{22} \textit{Ibid.}, p. 11.

\textsuperscript{23} \textit{Ibid.}.

\textsuperscript{24} \textit{Ibid.}, p. 3.

\textsuperscript{25} \textit{Law of the People's Republic of China on Commercial Banks} (December 27, 2003, 2015 Amended), Article 34.

and the implementation document directs “[a]ll financial institutions…” to “provide credit supports to these investment projects.”

Fitch Ratings found that “Banks Follow State Directives: China’s commercial banks…are still expected to support policy objectives and align their strategies with the State’s broad economic goals, and are frequently urged to do so. That suggests China remains a centrally planned economy despite financial reforms and effort at rebalancing the economy that had implied a greater role for market forces.” Indeed, the PBoC meets frequently with large banks to ensure that their lending decisions align with the PBoC and government objectives. PBoC “window guidance” on where (and where not) to direct credit is industry- and sometimes firm-specific.

Commercial banks in China primarily engage in the business of term lending; they generate the bulk of their revenues from collecting deposits and lending them out. In China, large banks lend primarily to large, state-owned enterprises. The result is that, in the case of many loans, both the lenders (large SOCBs) and the borrowers (SOEs) are state-owned and -controlled. According to the World Bank, the largest cost of state-ownership and control in China is “disintermediation of the non-state sector, especially micro, small, and medium enterprises that have significantly less access to formal financial institutions than state enterprises and large firms.” State-ownership in the banking sector allows the state to determine much of where capital is allocated in China. This has resulted in the government using the banking sector as a key policy instrument to allocate capital to priority industries. Because of this important policy role, banking sector reforms have lagged compared to other sectors in China. Even after reforms that turned many SOCBs into shareholding companies, China’s banking sector still exhibits a higher degree of state-ownership than banking sectors of countries at similar stages of economic development.

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27 Ibid.


30 “Bailing China ‘In’ to the Great State Refinancing,” PRC Macro, February 19, 2016, p. 3.


34 Ibid. pp. 28, 119

35 Ibid.

36 Ibid., p. 115.
The presence of state ownership on both sides of major portions of lending portfolios leads to significant distortions in lending decisions. Implicit government guarantees on loans made by state-owned banks to SOEs are a consequence of state ownership and the strategic importance the government attaches to SOEs.\textsuperscript{37} Government assumption of the risk on these loans incentivizes both state-owned and non-state-owned banks to lend to SOEs, even if it is clear over time that SOEs are not putting the funds to best (or even productive) use.\textsuperscript{38} Perhaps more importantly, these implicit government guarantees remove banks, to a large extent, from the essential business of effectively assessing, pricing, and managing risk.\textsuperscript{39} But the problem is even more than that. In China, the commercial business of pricing risk from a data and analytical standpoint is just beginning – so not only do banks not effectively price risk because of implicit government guarantees, but they are not incentivized to learn and develop the capacity to do so.\textsuperscript{40} Consequently, from a system-wide resource allocation standpoint, banks lend imprudently to SOEs. At the same time, the lack of effective risk pricing encourages imprudent borrowing and investment on the part of SOEs.

Soft budget constraints (i.e., the lack of any meaningful budget constraint that makes a company responsible for its own investment or production losses because the company receives financial assistance or support to cover those losses on an ongoing basis) are another consequence of state-ownership and control and the policy role banks play. Soft budget constraints exacerbate the problems of implicit guarantees and moral hazard by insulating SOE managers from the consequences of bad or imprudent production and investment decisions, which have been a major source of vulnerability.\textsuperscript{41}

From the standpoint of basic resource mobilization and financial intermediation, China’s banking sector has successfully channeled funds from savers to investors and financed the country’s economic growth and development. However, this financial intermediation has come at a relatively high price: financial repression due to interest rate controls, which deprives China’s savers of an appropriate return, and systemic credit misallocations that result from banks that are not solely motivated by profit and commercial considerations and big borrowers that enjoy implicit guarantees and soft budget constraints. Market-based banking systems operate to allocate credit to its best use, or at least to good use. But in China today, a significant and


\textsuperscript{40} “China: Moving Towards a New Monetary Policy Era,” \textit{BNP Paribas}, November 4, 2015, p. 2.

\textsuperscript{41} “Resolving China’s Corporate Debt Problem,” \textit{International Monetary Fund}, WP/16/203, October 2016, pp. 7, 14.
growing share of total credit is being put to unproductive use, with potentially significant consequences of troubled and non-performing loans.\textsuperscript{42}

The problem of systemic credit misallocation is evident in the extent of recent credit flows to the private non-financial sector (non-financial corporations, both publicly and privately owned; households; non-profit institutions, but not the government). Bank loans as percentage of GDP continues to increase,\textsuperscript{43} and this credit growth is concentrated in the corporate sector at a time of rising financial stress, falling profitability and growing inter-enterprise payment arrears.\textsuperscript{44} The banking sector continues to over allocate resources to SOEs, which account for only 16\% of value-added (down from 40\% a decade earlier), but half of total bank credit, even though they are on the whole the most indebted and least productive enterprises in China.\textsuperscript{45} Credit allocation has also been driven in large part by continued financing to non-viable companies in industries with over-capacity.\textsuperscript{46} The share of loans going to firms with low debt-service capacity is increasing,\textsuperscript{47} and the lenders to these firms are increasingly smaller, under-capitalized and under-provisioned banks that are least able to manage the increased risk.\textsuperscript{48} Roughly two-fifths of new debt goes toward interest on existing loans, and in 2014, 16\% of the 1,000 biggest Chinese companies owed more interest than their earnings before taxes.\textsuperscript{49} At the same time, however, the largest banks and to a lesser extent the joint-stock banks are, at the margin, stopping or slowing loan growth to these risky sectors and shifting their business focus more towards consumer lending.\textsuperscript{50} While this marginal shift in business focus is not irrelevant, the credit intensity of


\textsuperscript{44} “Global Financial Stability Report,” International Monetary Fund, April 2016, pp. 13-16.


\textsuperscript{46} Ibid., p. 5.

\textsuperscript{47} “Resolving China’s Corporate Debt Problem,” International Monetary Fund, WP/16/203, October 2016, p. 7. See also “People’s Republic of China: 2016 Article IV Consultation – Press Release; Staff Report; and Statement by the Executive Director for the People’s Republic of China,” International Monetary Fund, IMF Country Report No. 16/270, August 2016, p. 10.

\textsuperscript{48} Bedford, Jason, “Are We Through the Worst of the Credit Cycle? What the Banks Tell Us,” UBS, November 1, 2016, pp. 17-18. See also Bedford, Jason, “Have the Bailouts and Recapitalizations Begun?” UBS, August 11, 2016, p. 6.


\textsuperscript{50} Bedford, Jason, “Are We Through the Worst of the Credit Cycle: What the Banks Tell Us,” UBS, November 1, 2016, p. 14. It should be noted that the largest banks and joint stock banks continue to lend to these risky sectors.
GDP (new credit per unit of additional GDP) has doubled since before the 2008 great financial crisis and continues to rise, as the efficiency of investment has fallen significantly. At the end of 2015, total credit and bank credit to the private non-financial sector stood at 202% and 153% of GDP, respectively, with a very high total credit-to-GDP ratio some 27% over trend. This is well over the 10% that the BIS considers a warning signal, and suggests credit growth that far exceeds optimal financial deepening for a country at China’s level of economic development.

Overall credit growth in China indicates a worsening efficiency of credit allocation, weak governance, forbearance and soft budget constraints, without regard to underlying economic fundamentals that would result in credit tightening. Particularly, in the lower growth environment that China now finds itself in, there should be in aggregate no new (or at least less) lending to firms that are no longer economically viable and more lending to firms that are viable.

Non-performing loans (NPLs) and special mention loans (SMLs) (loans with which borrowers are experiencing difficulties) have increased rapidly in recent years, and their apparent levels and continued growth suggest the existence of both loan pricing and credit allocation problems. An accurate picture of the NPL and troubled loan situation might tell us the true scope and extent of the loan pricing and credit allocation problems, but such a picture is difficult to come by in China. Official figures of NPLs and SMLs, about 5.5% of total loans at the end of 2015, appear to significantly underestimate the full extent of the problem. The reasons for this include debt rollovers and flexible and insufficiently forward-looking loan classification standards.


This “extending and pretending” problem applies much more to SOE loans and the loan books of the biggest banks than it does to non-SOE loans and books of smaller banks. The IMF estimates a loans-potentially-at-risk rate, an indicator of potential trouble ahead, of 15% or more. These are loans held by companies with insufficient income before taxes to cover their interest obligations.

The IMF estimate likely underestimates the full scope of the problem. The estimate above does not include a large share of the rapidly growing shadow bank lending (discussed below), where credit risk is generally higher than in the formal banking sector and perhaps one-half of shadow banking products poses an elevated risk of default and loss. It also does not account for bad debt securitization, which is relatively new and a negligible part of the market, or for NPL disposal through asset management companies (AMCs). AMCs were first established in 1999 to deal with the huge banking sector NPL problem at the time and help China’s four largest banks clean up their balance sheets. Although these AMCs were to have a limited life span, they remain in operation today and continue to bleed NPLs out of the system. The original ten-year life span of the AMCs suggests they were established to deal with what was supposed to be a temporary problem. Their continued existence suggests that they have been simply treating symptoms, and not addressing underlying causes, of the NPL problem. The AMCs also refinance loans, which in many cases just delays NPL recognition, and banks sell some NPLs through repurchase agreements to AMCs, where the bank agrees to buy back the loans at a future date. For these reasons, many believe the actual NPL rate is much higher than official estimates suggest.

The role and purpose of AMCs in China and the efficacy of their efforts is not clear. Bank balance sheet clean-up, in principle, can help banks manage their bad debt problems if it does not obscure the true scope and extent of the NPL problem or exacerbate the problems of moral hazard and underlying soft budget constraints. AMCs are buying NPLs from banks through auctions at a discount, and that is one important step towards imposing market discipline. However, AMCs, banks and debtor firms are also involved in transactions wherein the creditor


61 “Resolving China’s Corporate Debt Problem,” International Monetary Fund, WP/16/203, October 2016, p. 4.


64 “Lipstick on a Pig,” The Economist, August 24, 2013.

65 Bedford, Jason, “China’s AMCs: Cleaning Up or Kicking the Can?” UBS, February 6, 2017, pp. 1, 11.

bank extends low-interest rate financing to an AMC, which then makes an interest-only, refinance loan with extended payment terms to the (distressed but still current) debtor firm, which, in turn, uses that financing to continue servicing its bank debt. This appears to be a roundabout way of rolling over loans to distressed borrowers, which may prolong and even exacerbate the NPL problem. Interestingly, the creditor bank and AMC often share the same shareholders, which often include the central or local government, or some other government-linked entity. A government-imposed alignment of interests can facilitate and even encourage non-arm’s-length dealings focused on managing symptoms of the problem, not its underlying causes. In addition, the administrative relationship between the government and the SOEs, banks and AMCs it owns are horizontal, not vertical, in nature, i.e., the central government administers centrally-owned entities and the local governments administer locally-owned entities. AMCs in China therefore operate at both the central and local level. Local AMCs have only recently been established and are limited to two per province. This binding limit at the local level and common ownership of the banks and AMCs raises the possibility of rationed access to AMCs that will favor state-owned banks.

This is not to say that the government has not made any attempt to address causes of the NPL problem. There are ongoing government efforts to do so, more on the operational side and less on the institutional side. Government efforts are aimed at strengthening bank operating fundamentals, specifically loan classification standards, capital and loan-loss provisioning, and risk pricing and management procedures. Progress has been achieved in this regard, but much remains to be done. Where these efforts ultimately lead, and when, is unclear because the lack of (i) effective risk pricing; (ii) large-scale misallocation of credit; (iii) capital inadequacy; and (iv) chronic and systemic NPLs are in large part all just symptoms of the problem of the state’s pervasive and intrusive role in the market, at both the local and central level.

### 2.2 Interest Rate Controls and Dynamics

**Benchmark Lending and Deposit Rates**

The previous section analyzed systemic loan pricing and credit allocation issues directly attributable to the state’s pervasive and intrusive role in the market. In this section, given the full,
nominal interest rate liberalization that recently occurred in China, the analysis turns to the loan rate-setting process from the bank’s perspective.

As recently as 2013, the PBoC set benchmark lending (and deposit) rates on an administrative basis, as well as floors (ceilings) under (above) which banks could not set their loan (deposit) rates. The deposit rate ceiling ensured that financing for China’s economic growth and development remained cheap. This came at the expense of China’s household savers, who had limited investment options due to capital account restrictions and underdeveloped securities markets. In effect, banks enjoyed a largely captive market for deposits and therefore did not need to compete for funding. The combination of a lending rate floor and a deposit rate ceiling effectively guaranteed banks a minimum mark-up on all the RMB loans they made.

This guaranteed minimum mark-up had several consequences. First, banks were not incentivized to price their product to ensure business success and their own economic viability because the minimum mark-up did that for them. Second, banks were incentivized to lend past the point where normal market prudential concerns would dictate they slow or stop the flow of funds, since the minimum mark-up remained fixed and independent of loan volume. Third, banks were conditioned to view loan pricing as more an administrative process and less a market process. Banks did not collect and analyze credit and market data to price risk because there was no need to. Consequently, such data largely did not even exist. Further reinforcing these tendencies were the fact that loans to the largest bank clients (SOEs) were at least implicitly guaranteed, and that banks’ long-held and well-founded expectations were that they were either too big or too important to fail.

Although the last remaining formal interest rate controls have been removed – the floor on lending rates in July of 2013 and the cap on deposit rates in October 2015 – the PBoC continues to publish benchmark deposit and lending rates, which are now referred to as “reference rates.” With these reference rates, the PBoC intends to guide China’s banks through an orderly transition to full interest rate marketization.

While there may be some legal or policy distinction between the terms “benchmark rates” and “reference rates,” there appears to be little practical effect of this change in the labels. The PBoC and other PRC government agencies continue to refer to “benchmark interest rates” in notices

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76 Ibid.


published in 2016, including one that directs lenders to set mortgage rates on the basis of the PBoC’s benchmark rate, \(^79\) and a recent PBoC working paper found that benchmark deposit and loan rates remain the primary basis for pricing deposits and loans. \(^80\) According to Fitch Ratings, “[t]he removal of the cap on Chinese banks’ deposit rates reinforces the authorities’ commitment towards financial reform, but will have no meaningful impact on deposit rates in the near term.” \(^81\) Indeed, actual deposit rates are still closely tied to the benchmark deposit rate, \(^82\) and since benchmark deposit rates are well below market-clearing levels, \(^83\) actual deposit rates are also still well below market-clearing levels. Fitch Ratings stated further that although “greater financial liberalization is a positive market development…we hold to our view that Chinese banks may still be bounded by regulatory guidance.” \(^84\) Article 38 of China’s Law on Commercial Banks states, “a commercial bank shall determine its loan rate in accordance with the upper and lower limit of loan rate set by the People's Bank of China.” \(^85\) China amended this law in 2015, but left Article 38 untouched. The implications of that for banks and the loans rates they set are uncertain.

In 2013, the PBoC launched the loan prime rate, essentially an average of commercial banks’ lending rates to their best clients, in an attempt to establish a reference rate that would encourage market-determined loan pricing. \(^86\) But if commercial banks for whatever reason are, to a large extent, still referring
g to the PBoC reference rate for loan pricing purposes, the loan prime rate would track the reference rate and in doing so would not function as an independent reference rate. Data indicate this is indeed the case. In 2015, two years after the lending rate floors were removed,

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approximately 90% of rates still clustered closely around the benchmark.\textsuperscript{87} The IMF reports rates on 40% of bank loans are now 10% or more above the PBoC reference rate.\textsuperscript{88} But these spreads apply primarily to loans to private borrowers. SOEs and other state-linked borrowers continue to have access to credit near the reference rate, because of the implicit government guarantees they enjoy.\textsuperscript{89} Thus, the wider credit spreads for private borrowers results from interest rate liberalization in an institutional context in which government policy directives and a lending policy bias favors SOEs and other state-linked borrowers.\textsuperscript{90} That is, interest rate liberalization has made explicit the price effect of private sector credit rationing that interest rate controls obscured before.

\textit{Interbank Rates}

The distortive effects of PBoC interest rate guidance and administratively set reference rates (past and present) can be seen in the context of the interbank market. Although controls on formal banking sector lending and deposit rates were removed only in recent years, controls on interbank lending and repo rates have long been removed.\textsuperscript{91} Accordingly, the Department analyzes whether interbank lending and repo rates can be considered market-driven and used as a benchmark, as well as the related question of whether rates on retail loans funded from interbank borrowing can be considered market-driven.

Normally, in a market system, retail lending rates (as well as other financing rates, both short- and long-term) tend to rise and fall with changes in the (wholesale) cost of funds in the interbank market. Thus, households and enterprises tend to pay more for loans when interbank funding is relatively scarce (when interbank rates are relatively high), and they pay less when interbank funding is relatively abundant (when interbank rates are relatively low). These linkages between the interbank market and retail financing rates, of course, work both ways. So, for example, when household or enterprise loan demand falls (rises), loan rates tend to fall (rise). This fall (rise) in loan demand reduces (increases) demand for funds in the interbank market, which decreases (increases) the relatively scarcity of funds, which in turn tends to reduce (lift) interbank rates. In this way, because of these inter-market linkages, interbank rates reflect the true scarcity of capital, and it is in this sense that they are market-determined.

In China, however, the inter-market linkages necessary to make interbank rates market-determined are weak. While linkages between interbank rates and retail financing rates are growing and developing, the PBoC’s \textit{administratively set} interest rates remain an important


\textsuperscript{90} \textit{Ibid.}

The weak linkages between interbank rates and retail financing rates results directly from banks referring to the PBoC’s administratively set reference rates rather than their interbank cost of (borrowed) funds when setting their loan rates, i.e., when pricing their loans. Ongoing reforms efforts are focused on increasing banks’ use of and reliance on market-determined pricing protocols, which would strengthen linkages between interbank rates and bank lending rates, but long-standing pricing practices are difficult to change, particularly when (a) the PBoC continues to publish reference lending and deposit rates for purposes of guiding the market, and (b) there is a lack of policy clarity on the state’s role in the market.

3 SHADOW BANKING

The Financial Stability Board, an international body that monitors and makes recommendations about the global financial system, broadly defines shadow banking as credit intermediation involving entities and activities outside the regular or formal banking sector. “Outside” can mean entities, activities and an institutional setting wholly different and separate from those in the formal banking sector. So, shadow banking is sometimes no more than traditional informal finance, where outside any formal institutional setting, small, private, independent lenders serve...
households, small private businesses and others underserved by the formal banking sector, with little or no regulatory oversight. But that is not quite the situation in China today. Instead, we see an institutional setting not unlike that in the formal banking sector.

Trust companies, the largest lenders in the Chinese shadow banking sector, are non-bank financial institutions (NBFIs) that combine bank and investment company functions. Most trust companies are state-owned; 59 of 68 licensed trust companies in China are owned by SOEs, large state-owned financial groups or local governments. These 59 companies together account for 92% of total trust assets under management. State ownership, per se, does not necessarily carry any negative implications from a market distortion standpoint. However, in this situation, state ownership is pervasive, if not systemic, and there is, from the perspective of a local government seeking out financing, little difference between state-owned trust companies, on the one hand, and state-owned banks that local governments can and do pressure to lend to SOEs, on the other hand. So we see trust companies lending, in increasing volume, to local government-owned financing vehicles (LGFVs) with inadequate risk pricing, even though LGFVs remain highly indebted and financially stressed with limited access to formal bank financing and limited capacity to repay their debt, which would likely be non-performing if not for fiscal subsidies and special accounting practices.

Non-financial companies lend and borrow money between themselves in the form of entrusted loans, which accounts for a sizable share of shadow banking. These loans often involve a bank facilitating the transaction for legal reasons, sometimes involving on-lent bank funds borrowed by the first company. The first company can be an SOE leveraging its preferential access to bank credit. Corporate subsidiaries account for 74% of this lending, and 7% is accounted for by more loosely associated group affiliates. Moreover, it appears that entrusted loan transactions are often undertaken for purposes other than commercial lending. For example, entrusted loans are a key link in a daisy chain of multi-party transactions that enable banks to engage in shadow

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banking activities (see discussion below). Such loans have grown in volume dramatically in recent years\(^\text{106}\) as bank-driven shadow banking activities have grown rapidly.\(^\text{107}\)

Banker’s Acceptances (BAs) also account for a sizable share of total shadow banking assets.\(^\text{108}\) BAs are essentially IOUs issued by a bank client that constitute a claim on the bank. It is in effect an off-balance sheet loan from the bank to the bank client typically backed by the client’s deposits with the bank. BAs are priced on the basis of either bank deposit rates (cost of funds basis) or bank lending rates (opportunity cost basis), both of which are set on the basis of administratively set PBoC reference deposit and lending rates. Therefore, neither is fully market-determined (see discussion under Interest Rate Controls and Dynamics).

Aside from the overlap in formal banking sector and shadow banking institutional settings, there is also overlap in the entities that operate in shadow banking and the formal banking sector. Shadow banking in China is not just credit intermediation involving NBFI s and their activities outside the formal banking sector, but also includes SOE and bank (off-balance sheet) activities. In fact, much of shadow banking is bank-driven activity that is the result of (1) financial repression; (2) the government’s response to the great financial crisis of 2008 and the unprecedented credit expansion that followed; (3) the opportunities that were created for state actors to participate in off-balance sheet activities; and (4) the incentive to do so given the large difference in regulatory burdens on the formal banking sector and shadow banking.\(^\text{109}\) Thus, much of shadow banking in China is formal bank channel lending flowing or spilling over into the informal finance channel because of binding regulatory constraints that limit the flow of loans in the formal bank channel much more than they limit the flow of loans in the informal channel. Roughly two-thirds of shadow banking is effectively “bank loans in disguise,” where a bank serves as the driving force behind a loan transaction and assumes all the risk, but “channels” new loans through a non-bank financial institution (NBFI) intermediary to avoid costly capital and loan-loss provisioning requirements, reserve requirements, and government lending directives.\(^\text{110}\)

For example, Trade Beneficiary Rights (TBRs) and Directed Asset Management Plans (DAMPs) are two investment vehicles that banks use to make new loans that they keep on their books as investment products, rather than loans, thus avoiding the cost of meeting reserve, loan provisioning and capital requirements. A typical TBR/DAMP transaction involves the (loan) originating bank, a trust or securities company, a corporate borrower, a bridge company and a guarantee bank, and it goes something like this: the bank first designates the corporate borrower, the bridge corporate and the guarantee bank. The bridge company then makes an entrusted loan


\(^{107}\) Bedford, Jason, “Shadow Loan Books, WMPs and a Rmb1trn Capital Hole,” *UBS*, June 2, 2016, p. 3.


to the designated corporate borrower that may or may not involve an exchange of capital. The trust or securities company then invests in the entrusted loan by buying rights to the interest payment cash flow. The guarantee bank provides a guarantee and the originating bank, in the final move, invests in a TBR/DAMP with the trust/securities company.\textsuperscript{111} The entrusted loan, which delivers funds to the designated corporate borrower, is a key link in this chain of transactions. It is therefore not surprising that rapid growth in entrusted loans in recent years\textsuperscript{112} has accompanied the explosive growth in these investment products, over a five-fold increase between 2012 and 2015, to nearly RMB 13 trillion at the end of 2015.\textsuperscript{113} This is despite a recent regulatory crackdown on bank-trust activities\textsuperscript{114}.

Off-balance sheet bank activities in shadow banking, as well as NBFI non-channeled lending, are in large part funded through wealth management products (WMPs). WMPs are essentially investment products sold by banks through trust companies (virtually all state-linked) and other NBFIIs, as well as independently through NBFIIs, that retail investors see as a high-yield, risk-free substitute for bank deposits. The estimated stock of such WMPs increased from nearly RMB 13 trillion in 2012 to over RMB 44 trillion in 2015.\textsuperscript{115} So although there are regulatory caps on the share of loan assets underlying a WMP, such funding has nevertheless fueled the rapid growth of NBFI lending.

The available evidence is that many shadow banking loans are of a non-commercial nature and include refinanced troubled or special mention loans in support of economically unviable firms or financially stressed LGFVs.\textsuperscript{116} This high-risk lending by banks (working with non-bank financial institutions (NBFIIs)) is \textit{growing} rapidly and \textit{increasingly} concentrated in smaller banks that have chronically and manifestly inadequate capital buffers, loan-loss provisioning and risk weighting.\textsuperscript{117} This is a spillover into shadow banking of credit misallocation and risk-pricing problems in the formal banking sector that reflect lending fundamentally inconsistent with commercial considerations.

\begin{itemize}
\item \textsuperscript{111} Bedford, Jason, “Shadow Loan Books, WMPs and a Rmb3.1tn Capital Hole,” \textit{UBS}, June 2, 2016, p. 17.
\item \textsuperscript{112} “Quarterly China Shadow Banking Monitor,” \textit{Moody’s Investors Service}, April 2016, p. 7.
\item \textsuperscript{113} Bedford, Jason, “Shadow Loan Books, WMPs and a Rmb3.1tn Capital Hole,” \textit{UBS}, June 2, 2016, p. 3.
\item \textsuperscript{114} \textit{Ibid.}, p. 1.
\end{itemize}
The spillover problem is exacerbated by the implicit guarantees and soft budget constraints faced by many of the state-owned or state-linked lenders and borrowers, which encourage and facilitate lending, borrowing and investment in pursuit of local government policy objectives. The distortionary effects of implicit guarantees can also be seen on the funding side of shadow banking, in the context of WMPs. Retail investors treat WMP investments as fully protected and backed by a bank or ultimately the government. They therefore accept a lower yield than they would otherwise. Investors have been piling into WMPs, as indicated by growth figures above, particularly those sold by smaller banks and NBFIs. These smaller institutions tend to be more aggressive in pursuing risky investments. Because investors are willing to accept returns lower than what would reflect the true risk of the investment, the cost of funds for the borrowers is lower, and borrowers demand more funds than they would if the interest rate reflected the true risk. Thus, the underpriced funds feed and compound the spillover of risk pricing and credit misallocation problems noted above.

Regulators are working to contain and address this channel lending problem as bank-NBFI transactions become more complex and opaque, and as business shifts away from existing channels involving more regulated trust companies to new channels involving less regulated securities and fund management companies. But because regulators might feel pressure to balance (1) the government’s economic growth imperatives and (2) the need for reform and the economic and financial pain that would entail, the regulatory push has to date fallen short of what the IMF describes as a “more holistic approach, with harmonized treatment of similar institutions and products, and enhanced coordination and information sharing.” For example, the government recently issued Document 82, which essentially mandates the capital adequacy and loan-loss provisioning requirements that apply to loans also be applied to all credit assets (i.e., those that bear loan-like risks) in banks’ investment books. Document 82 also prohibits banks from shifting (hiding) non-performing assets off their books. However, Document 82 falls short of requiring that banks apply loan classification and impairment standards to these credit assets, which would force NPL recognition.

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There is a segment of shadow banking that is essentially made up by private actors on both the borrowing and lending sides. This segment is roughly 13.5% of shadow banking assets and 3.7% of total banking assets. The lenders are typically small micro credit companies, and the borrowers are small- and medium-sized firms with effectively no access to formal financing channels. These are lenders and firms that do not enjoy implicit government guarantees or soft budget constraints, or other forms of government support, of any kind. These small firms that are the borrowers bear the brunt of government policy bias and bank lending practices that favor SOEs and result in a credit rationing situation for those borrowers not so favored. This rationed availability of funds results in these small borrowers paying very high rates of interest on their loans, in excess of 30% per annum in some cases. Lenders charge these rates on the basis of a 20 percentage-point mark-up but still find themselves under-provisioned and lacking adequate capital, which suggest that there is inadequate risk-pricing, i.e., interest rates are too low. At the same time, however, due to effective credit rationing that negatively impacts the non-state sector, interest rates are arguably high relative to what they would be in the absence of the rationing. Even if this market segment were large enough to matter for CVD benchmarking purposes, there is no evidence to support a conclusion that these distortions simply cancel out in an arithmetic sense and together leave no problem and the price undistorted. Interest rates can be simultaneously distorted in opposite directions consistent with overlapping problems of financial suppression and credit rationing. The net effect is unclear, though the presence of the distortions is clear.

To sum up, shadow banking in China presents a mixed picture. Shadow banking attempts to meet the growing needs of China’s household and SME sectors, which are under-served by the formal banking sector. But it does so in the context of financial repression and credit rationing that favor the state sector, and within an institutional framework in which it is not and indeed cannot be isolated or insulated from the formal banking sector. As result, it is in large part a direct extension of the formal banking sector, and is thus directly impacted by the inadequate risk pricing and credit misallocations found therein.

4 Bond Market

China’s domestic bond market has become the world’s third largest, with the value of outstanding domestic bonds at approximately 48 trillion RMB. However, although nominally large, when measured as a share of GDP, China’s bond market ranks as only the tenth largest domestic bond market in the world; it was just 62% of GDP in 2015. China’s bond market


126 Bedford, Jason, “Has the Credit Cycle Peaked? What the Shadow Banks Say,” UBS, November 2, 2016, pp. 4-5.

127 Ibid.


129 Ibid., p. 8.

130 Ibid., p. 5.
grew by 35% in 2015, driven by growth in municipal and corporate bonds. Contributing to the growth of municipal and corporate bonds is the new budget law, passed in 2014, which permits local governments to issue bonds, and the relaxation of government restrictions on access to the market. All companies, not just those listed on exchanges, now have access to the corporate bond market, and the approval process has been simplified.

Government and municipal bonds, most of which are central government bonds, account for 32% of the market. Financial sector bonds, which are dominated by policy bank bonds, make up 34% of the market. Corporate sector bonds account for 33% of the market, and largely constitute short-term bonds including commercial paper and medium term notes, as well as enterprise bonds, which include local government bonds. About 91% of the bonds traded are traded in the interbank market, and 8% are traded on the stock exchange. In February 2016, China’s bond market was opened further to foreign investors. However, so far, foreign holdings of Chinese bonds remain approximately 2%.

4.1 State-Ownership and Control

State-owned and government-linked entities predominate both the supply and demand sides of the bond market. Ninety-four percent of all bonds are issued by government-owned entities, including policy banks, SOEs, local governments, and LGFVs. SOEs and LGFVs have issued an estimated 94% of the corporate bonds outstanding, including shorter-dated instruments such as commercial bills and medium-term notes. With commercial banks holding

131 Ibid.
137 Ibid., p. 9.
138 Apparently, the 2014 Budget Law does not prohibit LGFVs from borrowing from the markets, including the bond market. See “China Local Governments Revive Off-Budget Fiscal Stimulus,” Financial Times, September 21, 2016.
139 Ibid., pp. 32-33.
over 60% of all bonds and over 70% of Treasury bonds, government-owned entities account for the majority of bond holdings. Experts believe banks will remain the primary buyers of local government bonds in the near-term.

The fact that the parties on both sides of a bond sale are often state-owned or state-linked entities raises concerns about the possibility of non-arm’s-length relationships and “aligned interests” among the parties that do not characterize market-determined transactions. An example involves the local government bond-for-debt swap program that the central government recently implemented. The swap apparently did not involve any market, just a meeting between the local government and debtor LGFVs and the (loan) originating banks. The central government presided over the meeting and imposed several conditions on the parties, primarily on the banks. The banks would accept long-dated, low yield bonds issued by the local government in exchange for the high-interest short-term loans the banks had issued to the LGFVs. The bond rates, as required by government regulation, would reflect sovereign risk, and the bonds initially would not be tradeable. Banks received various forms of compensation from the government for their participation in the deal. It is, perhaps, possible to characterize this transaction as market-determined, if the bank’s participation is seen as voluntary, even though it had to be incentivized by the promise of government compensation. Voluntary participation is after all a hallmark of market-determined transactions. But this was not an arm’s-length transaction in which the parties negotiated the terms and conditions of the deal between themselves. It was instead a deal presided over by the government in which the parties negotiated with the government, rather than between themselves, where all parties involved are state-linked or state-owned. It might therefore be more accurate to describe this transaction as essentially a government-directed administrative action undertaken collectively by state-linked or state-owned entities, all in the pursuit of government policy (economic growth) objectives.

Aside from the government’s direct role in the market, the regulation of sovereign bonds remains fragmented and multilayered despite recent efforts to simplify and streamline the structure. In addition, under Article 16(4) of China’s Securities Law, recently amended in 2014, the investment of funds raised through the issuance of corporate bonds must comply with state industrial policies, and under Article 16(5), the yield rate on corporate bonds must not exceed the interest rate level set by the State Council. For example, corporate bond yield rates cannot

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exceed the PBoC benchmark deposit rate by more than 40%. In addition, in the recent past, at least, banks were required to purchase government bonds in volumes and prices dictated by the government to keep the government’s funding cost down.

4.2 The Yield Curve

In market-determined financial systems, a (risk-free) government bond yield curve typically serves as a reference point or benchmark for the pricing of corporate bonds, which are essentially marked up to produce a higher yield for risk the investor assumes. The government yield curve indicates the return the market demands as the tenor (maturity) of the bond increases or lengthens, i.e., as the bond investor is asked to commit her money over longer periods of time. A large and diverse group of bond buyers and bond sellers who operate at arm’s-length and have wide-ranging investment strategies and needs makes the market for government bonds highly liquid in the sense that bonds of all tenors are easily and readily bought and sold. That, in turn, ensures supply and demand sufficient to generate a market-determined yield for bonds of each tenor, and it is these yields that collectively make up a market-determined yield curve.

But this is not quite the situation yet in China. Due to market fragmentation and lack of a diversified investor base, liquidity remains relatively poor compared to large mature markets even by some emerging market standards. Commercial banks do 70% of all trading in the interbank bond market, but at the same time they hold 75% of all outstanding bonds to maturity. As a result, the benchmark effect of the Treasury yield curve remains weak due to lower trading volumes and frequencies; problems with the issuance structure impact the completeness of the yield curve and effectiveness of pricing.

4.3 Risk Pricing of Corporate Bonds

Implicit government guarantees do not necessarily raise market-distortion concerns. An implicit guarantee on a loan to a single company that simply shifts risk to the government might just be viewed as a subsidy to that company. But implicit government guarantees in China are not isolated; they are pervasive. Implicit guarantees, by removing any incentive for parties to

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recognize, price and manage risk, encourage them instead to see bond purchases and sales purely in paperwork or administrative terms, rather than as market transactions requiring careful consideration of economic and financial factors. In doing so, pervasive guarantees have over time materially impacted the market’s capacity to price risk. Market participants did not develop either the data or knowhow necessary to price risk simply because there was no need to. According to a recent IMF report, “the prevalence of implicit state guarantees prevents the appropriate (usually countercyclical) pricing of credit risk in the bond market and distorts credit allocation.”152

Risk pricing is difficult without data on historical bond default rates. For that data to exist, bond defaults must occur. However, bond defaults have only recently begun in China. Indeed, these defaults were so unprecedented that the attention given to them has been more about the change in practice and expectations than the severity of default risk.153 The market appears to be reacting to the limited number of defaults as expected, with increased rate differentiation in some market segments and a rise in bond rating downgrades. However, overall spreads over the government risk-free rate have not increased much. Spreads have recently increased for bonds rated A+ and below, which is a relatively small part of the market, but spreads have remained relatively stable for bonds related AA- and above, which account for most trades in the market.154 Bonds rated AA or above still account for over 90% of the market.155 A recent 2016 Bloomberg study suggests that many bonds rated AAA would, in fact, be rated junk if investment risk was properly accounted for.156 This is due, in large part, to the top-down approach used by domestic credit ratings, where ratings are based on the ownership of the institution (state-owned or non-state-owned) rather than on the stand-alone financial strength of the bond issuer.157 As defaults increase and historical data on default rates develops, and as the economic and financial impact of defaults is felt, the limited capacity of credit ratings agencies158 and bond sellers and bond buyers to price risk on a market basis will likely increase, from both a data and process standpoint.


155 “Resolving China’s Corporate Debt Problem,” International Monetary Fund, WP/16/203, October 2016, p. 15.

156 Recently, defaults on AAA- and AA-rated bonds have increased. As of May 2016, total defaults had already exceeded those of 2015, indicating that state guarantees are perhaps not what they used to be, and that risk is no longer even being transferred to the extent that it was previously. See “Look Closer: 57% of China AAA Bond Issuers Have Junk-Like Risks,” Bloomberg News, May 23, 2016.


The recent rapid growth of the bond market could signify the development of an independent market base source of financing. But it is much more likely, given the institutional settings that are similar in both the corporate bond market and shadow banking, that much of the recent growth in the market is attributable to the regulatory squeeze on shadow bank lending and an extension of the spillover problem (discussed in the shadow banking section) into the corporate bond market. Otherwise, it is difficult to explain the recent rapid growth in the corporate bond market in the face of an already highly leveraged corporate sector that is experiencing increasing financial stress, falling profitability and a growing inability to finance its debt. Borrowing costs remain quite low, and there was a 5-1 ratio of bond ratings upgrades to downgrades.

In summary, the available evidence indicates that bond prices in China are subject to substantial government interference in their supply and available prices, and the markets on which they trade appear unable to adequately default risks.

5 OVERALL ASSESSMENT

The Department looked at institutional and operational features of China’s credit and debt markets, including the formal banking sector, the interbank market, the bond market and “shadow banking,” and whether they distorted these markets to such an extent that interest rates in China cannot be used for CVD benchmarking purposes. The Department found that implicit guarantees, soft budget constraints, non-arm’s-length pricing and government policy directives fundamentally distort the market from both a risk pricing and a resource allocation standpoint. In addition, the Department looked at interest rate dynamics, which suggest that interest rates are not yet fully market-determined.

From a basic resource mobilization and financial intermediation standpoint, China’s banking sector has done its job of channeling funds from savers to investors and financing the country’s impressive economic growth and development. However, this financial intermediation has come at a relatively high price: (1) financial repression from interest rate controls, which deprives China’s savers of an adequate return, and (2) systemic credit allocation and risk pricing issues that result from banks that are not solely motivated by profit and commercial considerations, and big borrowers that enjoy implicit loan guarantees and soft budget constraints. A market-driven banking system operates to allocate credit to its best use, or at least to good use. In China today, a significant and growing share of total credit is being put to unproductive use.

We found these distortions to be directly tied to state ownership and control and to the state’s pervasive and intrusive role in the market. While state ownership does not necessarily preclude market-determined interest rates, the state’s role in the market in China extends far beyond state ownership. The state seeks to preserve a leading role for the state sector in China’s economy, in general, and in the financial sector, in particular. The state sees state-owned banks, at both the central and local government levels, as important government policy instruments, much as it sees state-owned enterprises as instruments (and objects) of state industrial policies.


160 Ibid. See also “Capital Markets Risky Returns,” The Economist, May 5, 2016, p. 5.
There is strong tension between (a) the policy role that pushes banks to continue viewing the business of lending as an administrative process, and (b) reform efforts that push banks to operate in a more market-oriented mode. The tension, in turn, produces mixed policy signals on the nature, scope and extent of the state’s role in the market that have deleterious effects on the growth and development of the market and the non-state sector. Perhaps for this reason, although there has been progress to date, de facto changes in bank business procedures and practices do not yet reflect full implementation of market-determined pricing principles, and the primary basis for loan pricing in China remains PBoC-set reference lending and deposit rates.

Full nominal interest rate liberalization was an important step, but only one step, along the path to market-determined interest rates, as the PRC government itself recognizes. In China’s still bank-dominated financial system, the state (at the central and local government levels) maintains effective control over the vast bulk of banking sector assets and has not resolved the inherent conflicts in an economic strategy wherein the state continues to use banks as government policy instruments and at the same time seek to give the market a decisive role in resource allocation. It almost certainly cannot do both – one need look no further than shadow banking to see this. It is for these reasons the Department determines that China’s interest rate structure is not yet market-determined, even though all nominal government controls on interest rates have been removed.

6 CONCLUSION

After conducting an analysis of China’s financial sector, including the formal banking sector, interbank markets, the bond market, and “shadow banking,” the Department has determined that China’s financial sector remains fundamentally distorted. Although direct interest rate controls have been removed since the last assessment in 2006, finding a market-determined interest rate in China is still not possible. Thus, interest rates within China cannot be used for CVD loan rate benchmarking or discount rate purposes.

☐ Agree
☐ Disagree

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