Economic Analysis

Interest rate liberalization gained momentum from China's plan of deposit insurance scheme

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On Sunday night, the State Council, the Chinese cabinet, circulated a draft of deposit insurance rules for public consultation, suggesting that the long-awaited deposit insurance scheme will come to the fore soon. The deposit insurance scheme will cover all the deposit-taking institutions and insure up to RMB 500,000 for every depositor (corporate or individual) per bank, which, as the People's Bank of China claimed, will provide full insurance coverage of more than 99.6% of depositors nationwide. In the meantime, the authorities will establish a new regulator for the upcoming deposit insurance scheme. The regulator is expected to run a deposit insurance fund collected from insured banks and implement banks' resolution if needed. However, some technical messages are still missing in the draft. For example, it doesn't say how much the new regulator will charge banks for the deposit insurance fund. Moreover, it doesn't specify when this deposit insurance scheme will set in motion although some domestic news media units reported that it could start as early as the second quarter of 2015.

This move came on the heels of the rise in deposit rate ceiling (10% to 20% above the benchmark) on November 21 accompanied by an unanticipated interest rate cut. It conveyed a strong message that the financial liberalization process, despite the recent economic slowdown, still moves forward steadfastly as the authorities vowed. Indeed, the establishment of national deposit insurance not only is a prerequisite for full liberalization of interest rates but also opens way for private capital to enter into the banking market, both of which happen to be the focuses of China's long-term structural reforms.

Nevertheless, its short-term impacts on banks could be manifold and uneven. It is very likely that banks' contribution to the deposit insurance fund cannot be fully passed through to the depositors, which might dampen banks' profitability. Moreover, the deposit insurance scheme de facto abolishes the government's current implicit guarantees for all deposits, which could further strengthen large banks' relative advantages over small banks in terms of their safety and creditworthiness. Relatedly, the abolition of implicit guarantee could arouse people's awareness of the risks in wealth management products, which have formed an important part of China's shadow banking activities but mainly were distributed by banks. On the positive side, it could help to curb the fast rise of China's shadow banking activities.

Looking ahead, we believe that China's authorities will continue to push for structural reforms of financial sector as they spelt out in the blueprint of the third Plenum last November. Particularly on interest rate liberalization, there is a good chance for the authorities to fully liberalize deposit rates by early 2016. Prior to that the authorities could introduce CDs of non-financial corporations and individuals to the interbank market and raise the ceilings of deposit rates next year.

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