THE EFFECT OF PARTIAL DEPOSIT INSURANCE

Sang-wook Kwak
(swkwak@hri.co.kr)

The government finally decided to implement the partial deposit insurance system next January as originally scheduled, but it will raise the insurance ceiling from 20 million won to 50 million won. This settlement can be seen as an attempt to preserve the government's policy credibility related to financial restructuring, while minimizing the shock to the financial market.

Advocates of deferring the partial insurance system argued that implementing the policy at this stage would cause an enormous shift of capital among financial institutions, resulting in a series of bankruns and a severe financial crunch. It seems, therefore, that the government tried to minimize the shock to the financial market by raising the ceiling from 20 million won to 50 million won.

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Despite the upward adjustment of the limit however, it seems that capital flux on some scale will be unavoidable. The size and direction of money flows will determine the problems that arise as well as the best responses.

Size of capital flows

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Among the financial institutions that can be insured, the total volume of deposits above 50 million won that are deposited into so-called "unhealthy banks" is estimated at 82.5 trillion won. The deposits over 50 million won held in merchant banks, mutual savings & finances, and credit unions is conjectured at 19.6 trillion won. Thus the maximum amount of funds that can flow out of unhealthy institutions is estimated at around 102 trillion won.

It is not likely that the whole volume will flow out however. Firms' deposits are

Table 1. Deposit Distribution and Likely Size of Movement

(trillion won)

	6 Sectors*	4 Sectors**	Unhealthy Banks	Merchant Banks, MSF, Credit Union	Size of Possible Capital Movement
Total Deposit	654.5	512.5	162.3	49.3	-
More than 50 million won		300.6	82.5***(A)	19.5(B)	102(A+B)
Likely Size of Movement		12.5(C)	9.9(D)	22.3(C+D)	

* banks, insurance, securities, merchant banks, MSF, credit union ** 6 Sectors minus insurance and securities *** special deposit, cash in bank and public fund excluded

difficult to move because they are usually connected with liabilities. In addition, because all special deposits and cash in banks are insured until 2003, these funds are not expected to flow out.

One can therefore focus on individual deposits to estimate how much money will escape. It is estimated that unhealthy banks hold 12.5 trillion won of deposits exceeding 50 million won, which will mature at the end of the year. Considering the recent difficulties for merchant banks, mutual savings & finance companies, and credit unions, at least 50% of the 19.8 trillion won of deposits in those institutions is expected to flow out. Thus, we can conclude that about 22.3 trillion won worth of funds will move at around the end of this year.

The direction of the future capital flux is relatively easy to predict. Considering the characteristics of funds, it is not likely that the deposits in securities and insurance will move easily. So one can expect that deposits in unhealthy banks, merchant banks, mutual savings & finance, and credit unions will flow to competitive commercial or foreign banks.

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While capital movement in the banking sector is expected to be large, inflow to the stock and bond markets is likely to be relatively small. The domestic stock market is severely depressed and a rebound is not foreseen for the time being due to domestic and foreign bearish factors. Meanwhile, the return rate in the bond market is excessively low, so there is a high possibility of a reactionary rise in the rate of return.

Clouds on the horizon

Although capital movements are not forecast to exceed the 20 million won limit, there is still anxiety that the system's introduction, coinciding with the exit of ailing firms, will bring added confusion to the capital market.

The shock will probably be most severe at merchant banks since deposits exceeding 50 million won amount to 88% of total deposits in the merchant bank sector. Considering that almost all medium sized enterprises are acquiring their short-term capital through the CP market, the deterioration of the merchant banks' capital brokerage function is sure to raise the possibility of bankruptcy for marginal firms.

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In addition, with mutual savings and finance companies (MSF) under higher credit risk with the recent exit of unsound companies, people in rural areas may suffer if MSFs lose their viability. This is because a specific portion of MSF loans were to individuals or small firms in rural areas. It is presumed that 57.2% of MSF deposits are worth over than 50 million won.

Meanwhile, the money escaping from unhealthy banks and merchant banks is expected to flow into money market deposit accounts of competitive domestic or foreign banks for the short term, to monitor conditions in the money market and find opportunities to move into more profitable havens. Thus, capital in the money market may continue "floating" for the time being. Furthermore, the phenomenon may worsen because the stock and bond markets currently are unattractive to short term capital in the market.

What should the government do?

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It seems that the government tried to accomplish two objects at the same time by implementing the partial deposit insurance system. First, it wanted to maintain the pace of the restructuring process, and second, it tried to minimize shocks to the financial market such as sudden capital movement.

In the face of assertions that the new system should be postponed, the government carried out its original plan, which has regained some confidence for the government's restructuring effort.

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The most urgent task is to support the purchasing power of merchant banks (which will be the hardest hit by the new system) in the CP market. As mentioned before, a lot of enterprises get their short term funding through the CP market. Thus, it is recommended that the central bank improve the CP purchasing power of merchant banks by buying repurchase agreements, a measure that would probably reduce bankruptcies of troubled firms.

Though the aggregate credit ceiling system has recently been improved, there is still a need to further raise the ceiling to supply enough credit to firms in liquidity trouble. The loan maturity of aggregate credit ceiling system is set at just 3 months, but it needs to be extended depending on conditions in the financial market and regional economy. In addition, although the central bank chairman can withhold the assignment within 10% of the credit ceiling, the limit should be extended to 15% to 20% when needed. VIP

Figure 1. Likely Movement of Funds and Its Effects