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Market discipline and deposit insurance

Asli Demirgüç-Kunt[a,*], Harry Huizinga[b,c]

[a] *World Bank, Development Research Group, 1818 H Street NW, Washington, DC 20433, USA*
[b] *Department of Economics, Tilburg University, Netherlands*
[c] *Centre for Economic Policy Research, London, UK*

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Abstract

Cross-country evidence presented in this paper suggests that explicit deposit insurance reduces required deposit interest rates, while at the same time it lowers market discipline on bank risk taking. Internationally, deposit insurance schemes vary widely in their coverage, funding, and management. This reflects that there are widely differing views on how deposit insurance should optimally be structured. To inform this debate, we use a newly constructed data set of deposit insurance design features to examine how different design features affect deposit interest rates and market discipline.

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1. Introduction

In the last two decades, we have seen a series of banking crises around the world where banks have become systematically insolvent. Banking crises have occurred in developed and developing countries alike. Prominently, the Asian crisis of 1997 involved banking crises in Thailand, Indonesia, Malaysia and Korea, with banks becoming insolvent after economic downturns and currency devaluations.

Systemic bank insolvencies involve huge costs to the banks themselves, their customers and to governments. Bank failures may lead to the destruction of a bank's information capital garnered in previously nurtured bank-customer relationships. A

*Corresponding author. Tel.: +1-202-473-7479; fax: +1-202-522-1155.
E-mail address: ademirguckunt@worldbank.org (A. Demirgüç-Kunt).

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disruption of bank lending and of the payments system may also cause a reduction in investment and other economic activity. Further, bank depositors potentially lose heavily because of bank failures. Last but not least, governments tend to incur large costs in remedying a banking crisis. To make financial system breakdowns less likely and to limit their costs if they occur, all countries of the world have financial safety nets in place. These nets are amalgams of policies including explicit or implicit deposit insurance, the central bank's lending of last resort, bank insolvency resolution procedures, and bank regulation and supervision.

Bank safety nets are difficult to design and administer, because they have the conflicting objectives of protecting bank customers and reducing banks' incentives to engage in risky activities. In several countries including the U.S., the financial safety net, structured to reduce the vulnerability of the financial system, appears to have had quite the opposite result. Indeed, Kane (1989) identifies the U.S. financial safety net, and notably fixed-rate deposit insurance and belated bank closures, as the single most important factor in explaining the catastrophic Savings and Loan crisis of the 1980s. Similarly, Demirgüç-Kunt and Detragiache (1998, 2002) find international evidence that the existence of an explicit deposit insurance scheme has contributed to banking system fragility.

To restrain bank risk taking, financial safety nets generally rely on two mechanisms: (i) market discipline, and (ii) bank regulation. Bank creditors can exert market discipline by withdrawing their funds, or demanding higher interest rates from riskier banks. In case of publicly traded banks, equity holders can also effect discipline. Bank regulators, in turn, can directly restrict a bank's operations, and prescribe corrective action if bank solvency is jeopardized. The challenge facing policy makers is to ensure that the financial safety net enables rather than undermines market discipline. There is a real danger that regulatory forbearance policies and overly generous depositor protection increase rather than reduce the excessive bank risk taking which has been the root cause of many bank failures.

A substantial literature discusses the potential effects of safety net design and implementation on market discipline. This literature proposes various design features such as limited insurance coverage, co-insurance, and private deposit insurance that leave some room for market discipline in an explicit (public) scheme of deposit insurance. See Kane (1999) for a general discussion, and Ely (1985), Calomiris (1997) and Wall (1989) for specific proposals concerning private deposit insurance and (uninsured) subordinated bank debt. For lack of empirical evidence, this debate about deposit insurance design has been entirely theoretical and hypothetical. Hence, we do not know whether deposit insurance design features that work well in theory work equally well in practice. The main purpose of this paper is to fill this gap in our knowledge.

There are several empirical studies on market discipline mostly for the U.S. that generally find support for the existence of some market discipline by bank creditors. Cross-country data, however, are necessary to see whether the extent of market discipline is affected by the existence of explicit deposit insurance.

This paper examines, first, whether market discipline through bank interest rates is affected by the presence of deposit insurance on a cross-country basis. Specifically,