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# Avoiding bank runs in transition economies: The role of risk neutral capital <sup>☆</sup>

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## Abstract

In a general equilibrium model with risk neutral and risk averse agents, we show that if banks issue both demand deposits and equity, then free banking is run-proof and efficient. In particular, we obtain the first best insurance solution if there is adequate risk neutral capital. If sufficient risk neutral capital is unavailable, then a partial suspension of convertibility is optimal. In general, therefore, policies like capital adequacy norms and deposit insurance are neither necessary nor desirable. © 2000 Elsevier Science B.V. All rights reserved.

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## 1. Introduction

Transition economies have a legacy of government control over the banking sector. Indeed, most, if not all, banks continue to be in the public sector in many

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of these economies. And, even when they are outside the direct ownership of the government, they are assured of government help in times of distress. Historically, the role of banks in these economies has often been more political, than economic. Not surprisingly, banks in transition economies have large amounts of bad loans accumulated over the years. Loss making banks, however, were able to survive as government budgetary support wiped out their losses.

Propping up loss making banks essentially imply that depositors are assured of their returns. Thus, there is implicit (if not explicit) deposit insurance in these countries. Consequently, depositors no longer discriminate against badly performing banks, and bank managers do not worry about the loans they give out. The net result is that, good projects subsidize the bad ones, increasing the cost of capital in the economy. This inefficiency restricts investment, and hence, growth.

Most transition economies are going through fundamental structural changes in both the real and financial sectors. For an efficient financial sector, it is important that the banking sector is built on a solid foundation. For this, it is imperative that banks face hard budget constraints. To make this constraint credible, governments must commit to allow banks to fail, if they perform badly. This calls into question the policy of government funded deposit insurance.

Diamond and Dybvig (1983) forms the theoretical foundation used by policy makers to argue for government funded deposit insurance schemes. According to the Diamond–Dybvig paper, a lack of deposit insurance can lead to a panic run. In this paper, we show that such panic runs can be avoided even in the absence of deposit insurance. We allow banks to sell equity as well as deposits. The presence of equity effectively solves the bank-run problem. In particular, we show that there exists an amount of risk neutral capital that is sufficient to ensure a run-free optimal outcome, and allow risk averse depositors to be completely insured (i.e., get full insurance coverage). In case the amount of risk neutral equity is smaller, then also runs can be avoided, but with less than full insurance for depositors.

Our model highlights the importance of adequate capital, as a market outcome, in preventing bank runs. Many authors have analyzed capital adequacy as a means to reduce the costs of subsidized deposit insurance schemes (Buser et al., 1981; Sharpe, 1978), without arguing that with adequate capital, deposit insurance is unnecessary. We go on to show the irrelevance of deposit insurance even with aggregate uncertainty.

In Section 2 we briefly summarize the literature on bank runs. Section 3 describes the basic parameters of our model. Section 4 develops the operation of the bank. The next section calculates the minimum amount of risk neutral capital that will give us the full insurance model. Section 6 deals with a situation where there is not enough risk neutral capital to guarantee complete insurance to risk averse agents. Section 7 concludes the paper.

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