Department of Economics

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Bank Stability versus Financial Development: A Generous Deposit Insurer's Dilemma

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Non-Technical Summary

- This paper evaluates Brazil's policy intervention of increasing the deposit insurance coverage limit in 2006, 2010 and 2013 on bank stability and financial development.
- To account for the multidimensional nature of financial development, I use a unique dataset that measures accessibility, depth and efficiency in financial markets and institutions.
- I use the synthetic control method to overcome the bias of choosing the control unit associated with most policy evaluation methods.
- In contrast to most methods where the control unit selection is at the researcher's discretion, the synthetic control method uses an algorithm to identify a weighted combination of control units.
- The method uses the control units to simulate a counterfactual distribution of bank stability and financial development in the absence of policy intervention.
- To the best of my knowledge, this is the first study to apply the synthetic control method to the deposit insurance literature.
- I find that during the non-crisis period, an increase in the coverage limit enhances depositor confidence and increases banks' risk-taking behaviour, which creates a policy trade-off such that financial development is supported at the cost of bank stability.
- However, the results indicate that during a crisis period, bank stability is enhanced as financial institutions reduce their risk-taking behaviour, and financial development deteriorates as depositor confidence is not enough to offset the negative effect of an economic crisis.
- The results imply that policymakers should consider implementing a generous deposit insurance alongside some risk controls to reduce the moral hazard effect.

You can read the full paper here.