

Quiz #5

Emerging Financial Markets

1. What are the benefits (purpose) of deposit insurance?

- a. *Protect unsophisticated depositors*
- b. *Create a stable source of funds for the banking system – which prevents panics, runs, contagion and therefore instability of the banking system.*

2. What type of problem does a full government guarantee create?

Can create moral hazard behavior by banks. This may cause the inefficient allocation of funds, causing default and increasing the probability that the deposit insurance fund will have to pay depositors. In extreme cases, defaults arising from this moral hazard behavior will result in panics and contagion. Then, paying depositors may exhaust the insurance fund forcing taxpayers to pay the bill. Such a financial crisis could decrease economic growth if the banking system fails to intermediate funds efficiently.

3. List features of an “Optimal” deposit insurance system.

- Unsophisticated (small) depositors covered
- Sophisticated (large) depositors are not covered, forcing them to monitor banks
- Accurate and transparency information, so that depositors can monitor
- Strong government regulation and supervision of banks (since banks protect information and will not let it all out to the public, government has a role in monitoring banks through examinations)
- Adopt risk-based premiums – to discourage risk

4. What is an “Implicit Too-Big –To-Fail” Policy?

Government bails out large banks because of possible large adverse effects of a bank failure on the financial system or the economy. The central bank's actions may put in place an implicit full guarantee in the minds of depositors associated with large banks.