LESSONS FOR TRANSITIONAL AND DEVELOPING ECONOMIES FROM U.S. DEPOSIT INSURANCE REFORM

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ABSTRACT

Almost all countries—differing widely in economic and political structure and income levels—have experienced severe banking problems in recent years. Many of these banking problems may be attributed to poorly designed safety nets under banks, which increased their fragility by encouraging lower capital ratios; more risky asset and liability portfolios; and forbearance by bank regulators in applying prudential sanctions on troubled institutions and resolving economically insolvent institutions promptly. The United States experienced such a crisis in the 1980s when 10% of its banks and 25% of its savings and loan associations failed, costing the taxpayers some $150 billion. As a result, the United States enacted major deposit insurance reform as part of the FDIC Improvement Act of 1991.

This chapter analyzes whether banking is more fragile than other industries and, if so, both the causes and implications. It concludes that banks are more fragile, but that this has translated into greater breakage (failure) only with the help of well-intentioned but counterproductive government policies. Particularly troublesome are state-owned banks, which are typically used to allocate credit by the government and are frequently insolvent and able to continue to operate only because of implicit government deposit insurance. These insolvencies need to be resolved before lasting deposit insurance reform can be successfully introduced.

After recapitalization, countries should copy much of the new deposit insurance structure in the United States, which focuses on structured early intervention and resolution (SEIR) in order to eliminate the moral-hazard and