

Re-examining the Case for Government Deposit Insurance: Reply

I stand by my earlier paper. To understand why, we need to consider two different cases, one corresponding to a situation in which the optimal contract is interpreted as depending on *expected* t , and the other corresponding to the optimal contract being interpreted as depending on *actual* t . In the first case, which was the one I focused on in my earlier paper [1], the banker makes a known loss (of $r_1 - 1$) on each period 1 withdrawal, and a known profit (of $R - r_2$) on each period 2 withdrawal. (Given that the banker pays out $r_1 > 1$ units to each period 1 withdrawer, but the productive process yields only 1 unit, it should also be clear that I did not “forget” that the period 1 withdrawers take out more than the productive process has yet produced.) The banker’s total profit or loss then depends on the relative numbers of agents who withdraw in each period, and, therefore, on the actual value that t takes: if a lot of agents withdraw early, the banker makes an overall loss; if a lot withdraw late, he makes an overall profit. (Dr. Hazlett’s claim [2] that the banker must *necessarily* make zero profits is thus incorrect, at least as it applies to the case I focused on.) It follows that the banker *will* pledge his wealth as shareholder capital *if* he expects t to be low enough, and the various claims made in my paper then naturally follow.

The alternative case is where the banker makes payments conditional on actual t . In this case the resource constraint faced by depositors tells us that they get out *exactly* what they put in, plus the return earned on the investment technology, and so the banker’s profit *must* be zero. Yet to conclude—as Hazlett does—that the banker would provide no capital because he would get no profit, is to miss the point. Instead, the appropriate conclusion is that there is scope for mutually beneficial gains from trade between the shareholder and depositors: if the shareholder can provide valuable reassurance to depositors at no cost, then all parties would be better off if the depositors pay the shareholder to reassure them. In fact, in the model, even the *smallest* positive inducement would suffice. We must therefore presume that the inducement *would* be offered and the capital *would* be pledged. Hazlett is consequently mistaken when she asserts that the pledge of capital is unlikely. Indeed, it is even more likely in this case than it was in the earlier one.

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References

1. Dowd, Kevin, “Re-examining the Case for Government Deposit Insurance.” *Southern Economic Journal*, January 1993, 363–70.
2. Hazlett, Denise, “Re-examining the Case for Government Deposit Insurance: Comment.” *Southern Economic Journal*, April 1996.