A Study on 2012-13 Cypriot Financial Crisis and Modeling the Effects of Deposit Insurance on Banking Crises

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ABSTRACT

This paper studies the 2012-2013 Cypriot financial crisis both empirically and theoretically. First, I provide a detailed empirical study on the origin, evolvement, and consequence of the 2012-2013 Cypriot financial crisis and the government bailout policies adopted in the crisis. Next, I build a theoretical model based on Diamond and Dybvig (1983) to examine two alternative bailout policies announced by the Cypriot government during the crisis: one policy that will not insure both large and small depositors and the other policy that will insure small depositors. I modify the Diamond and Dybvig model by introducing two types of depositors, and study how different insurance policies will affect the incidence of bank runs and consequently social welfare. My major result is that when small depositors are not insured, a self-fulfilling bank run will be much more likely to occur, causing huge social welfare losses.