The Political Economy of Bank Bailouts

Discussion of BHKV 2017

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Big picture and motivation

• Authors pose a great question:
  - Effects of decentralized vs. centralized decision-making in bank bailouts
  - Critical to the banking union in the EU
• But I am not sure motivating question and setting fit well
  - Are there really big institutional differences between association & local bailouts?
    ▪ Association is involved in all cases & politicians are probably involved (at least initially)
  - Association has much smaller information problems than the ECB
    ▪ Cross-country differences in how information is collected & in bank business models
    ▪ Your setting favors centralization
  - While I see some features or forces that apply to ECB setting, generally speaking I would be reluctant to draw strong conclusions
• I would ditch front end on decentralization and the banking union and instead make the paper about political forces in bailouts
Political forces in bank bailouts

• We already have prior work on how politicians influence lending, employment, etc. and that they do so around elections
  – Not so surprising that politicians would also meddle with bailouts
  – So first part is less novel

• Main contribution is evidence on the economic effects of politically motivated bank bailouts
  – Nice feature: Analyze lending, firm growth & productivity, local economy (including state debt) – Can look at “complete package”
  – Close in spirit to a welfare analysis

• Answer: Politicians use bailouts for personal motives and the economic and aggregate effects are negative and large

• Key questions: How plausible are the results & effects?
  – Much hinges on identification and instrument
**Key challenge**

- Bailout decision is clearly endogenous
- Many possible selection stories
  - Banks in more financially constrained municipalities are bailed out by savings association
    - These regions might have more potential because of fiscal constraints
  - Local politician has a lot of information about the distressed bank but also economic conditions in the region
    - Conditioning on this info poses a problem if unobservable to you
- Descriptive evidence shows that association and local bailouts are quite different (e.g., bank size, region)
  - Authors use the electoral cycle as an instrument
Exclusion restriction

• Ex ante, many concerns about the validity of the instrument
  – What if politicians stimulate the local economy, especially prior to elections? Seems plausible to me
  – Prior evidence on bank lending related to the electoral cycle
    ▪ Sapienza (2004) and Dinc (2005)
    ▪ For Germany and savings banks: Engelmaier/Stowasser (2015)

• Authors present evidence on (lack of) correlations between local conditions and pre-election dummy
  – But at present evidence is not very convincing
  – Strong priors & prior and in paper evidence
  – Any influence of cycle (before or after) on local conditions is concern
Suggestions

- Current model lags (-1) macro and bank variables: Why?
  - You want to purge local economic variation pre-election as possible
  - R² in Table 3 triples when you include local macro and bank controls

- Altonji, Elder & Taber (JPE 2005)
  - How large would selection on unobservables have to be?

- Use cooperative banks to create benchmark (BB data)
  - Would allow a much tighter fixed effects structure (region X time)

- ES (2015): Evidence that savings bank lending and public spending at the county level are substitutes
  - Explore pre-election lending & public spending
  - Effects are stronger in contested elections
Documented effects

• When banks are bailed out by politicians:
  – They perform more poorly after bailout (Δ in ROE 6.7%)
  – 7% more state bank lending subsequently
  – Banks continue old loans, rather than new lending (8-10%)
  – High productivity firms are missing out on 7% loan growth
  – Corporate asset sector growth is lower by 6.6%
  – Entry and exit rates decline by 4%
  – Negative but not statistically significant impact on GDP

• Generally speaking, the effects are HUGE
Are the effects plausible?

• IV effects are all much larger than OLS effects (1.5x)
  – Authors argue that this is a good thing – but should give us a plausible story for why selection goes in this direction
  – We know when IV goes wrong, bias is in the same direction as OLS, and IV > OLS estimates when instrument is weak
  – Not sure they report partial F-stats; eye-balling implied t-stats for instrument (Table 3), it is not clear that it is strong enough

• Be more specific about the mechanism
  – Convince us that bailout type is institutionally really different
  – More institutional detail & Table 2 (regressions for bank restructuring by bailout type)
Suggestions

• Finding valid instruments is tough (for all of us):
  – Plausibly exogenous (Conley, Hansen, Rossi, 2012)
  – Allows you to relax the exclusion restriction

• Provide more graphical evidence
  – Map out estimated relations in event time (not raw data)

• I really like “dynamism” analysis
  – Industry-adjust MPK (because you care about interaction)
  – But you have contract data – exploit this data for tighter design
  – Khwaja and Mian within-firm estimator
**Closing comments**

- Does the IV really run the intended horse race?
  - Local bailouts have pros (info) and cons (personal motives)
  - If the instrument works, it isolates the “con” as it induces variation in personal political concerns (election chances)
  - By construction, IV uses variation for the “con” and hence tells us about the bad bailouts; but not the tradeoff

- Why do local politicians do it?
  - Does it help them win elections?
  - What are they getting out of it? Just private benefits?
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