The Political Economy of Bank Bailouts

Discussion of BHKV 2017

Christian Leuz

Joseph Sondheimer Professor of Int. Economics, Finance & Accounting

CHICAGO BOOTH

The University of Chicago Booth School of Business

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)
  - Distress events & elections: Brown/Dinc (2005) and Liu/Ngo (2014)
- 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
  - R^2 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 <u>estimated</u> 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?

CHICAGO BOOTH

The University of Chicago Booth School of Business