

Lecture 7 – Subsidies and Bailouts (Risk Subsidies in the 20th Century)

0) Big Idea

Risk subsidy = a policy that lowers the private cost of taking risk by shifting loss-bearing to the state (e.g., guarantees).

- Unlike a **cash (lump-sum) subsidy**, a **risk subsidy** pays off *only if* someone takes more risk.
 - Politically attractive because fiscal costs are **opaque** (often off-budget), yet benefits are salient.
-

1) Why Governments Use Risk Subsidies

- Quiet transfers that don't show up fully in budgets.
 - Fit long-standing **government-bank bargains**: banks help the state; the state protects bank risk.
 - But: to preserve the subsidy's value, **prudential regulation** is kept weak/inexact → more risk-taking → more crises.
-

2) Deposit Insurance as Risk Subsidy (U.S. states, 1910s–1920s)

Research design: Compare *insured state banks* vs. *uninsured banks* in the same state and vs. nearby states (clean identification).

2.1 Hypotheses

- 1) **Insured banks attract deposits** away from uninsured banks.
- 2) **Insured banks take more risk**, visible in balance-sheet choices:
 - Lower **Cash/Assets**
 - Lower **Equity/Assets**
- 3) **Depositor discipline weakens** at insured banks: depositors stop rewarding prudence / punishing risk.

2.2 Findings

- **Deposit flows:** +25–30% deposits and loans at insured banks vs. controls (post-implementation, not mere passage).
- **Risk choice:** Insured banks cut **cash buffers** and **capital ratios** (economically large drops).
- **Mechanism (discipline test):**
- For **uninsured** banks:
 - ↑ Loans/Assets → deposits **leave**
 - ↑ Equity/Assets → deposits **enter**
 - ↑ REO/Assets (foreclosures) → deposits **leave**
- For **insured** banks: the same risk signals **don't move deposits** (effect neutralized).
- **Who drives it most? Young/small entrants** in counties tied to **WWI crop booms** (high-beta opportunities).
- **Outcomes:** When WWI price shock reverses, **insured systems collapse**; uninsured/national banks remain viable.

2.3 Contemporary recognition

- **FDR (1932)** opposed federal DI (“laxity in bank management and depositor carelessness”; fiscal drain).
- **Yet FDIC (1934)** passed via **log-rolling** with unit-banking interests; temporary → entrenched.

Takeaway: Deposit insurance **reduces market discipline, raises bank risk, and amplifies failure**, even when intended to stabilize.

3) Farm Credit System (FCS) & Ag Land Bubble (1970s–1980s)

Institutional setup: Government-backed, cooperative lenders → weak governance & soft budget constraints.

3.1 Economics of ag land value (Mark Carey insight)

- Commodity prices **mean-revert** in real terms → warranted land values shouldn't jump merely from temporary crop price spikes.
- **1970s:** Real farmland prices **surge ('72–'82)** → **unwarranted** by fundamentals → classic **bubble**.

3.2 Who lent into the bubble?

- **Commercial banks** with shareholder capital **pulled back** as prices detached from cash flows.
- **FCS expanded** to near **100% of new ag loans** by the peak, underwriting on **appraisals** that simply capitalized rising comps → **credit fuels prices → prices justify credit** (feedback loop).
- Collapse in the 1980s; fixes raised capital but core incentive/governance issues largely persisted.

Lesson: Government-subsidized credit + non-shortable asset (land) = strong pro-bubble dynamic.

4) Thrift (S&L) Collapse (1980s)

Policy trilogy (New Deal, 1934): 1) **Insured thrifts (S&Ls)** mandated into housing → de facto subsidy to **30-yr fixed-rate** mortgages.

2) **Fannie Mae** (secondary market) → further subsidy to conforming mortgages.

3) **FHA** → guarantees for borrowers who couldn't qualify conventionally.

4.1 Interest-rate risk at heart

- Market never produced widespread **30-yr fixed** loans unaided: **duration risk** too large.

- 1979–81 rate spike → massive **mark-to-market losses** at S&Ls (assets fixed-rate, funding short).
- Rule of thumb: +1% long-rate move can wipe **~15%** off a 30-yr bond's value.

4.2 Gambling for resurrection

- With equity gone, S&Ls lobbied for **expanded powers** ('82): CRE, junk bonds, etc.
- **Brewer result:** Deeply impaired S&Ls took the **riskiest** bets; well-capitalized S&Ls didn't.
- **Politics:** Resolution delayed until **post-1988 election** (FIRREA, 1989).
- **Fiscal cost:** touted ~\$300B; realized ~\$150B after asset sales, but **true economic burden** closer to the higher figure.

Lesson: Subsidizing unhedged long-duration mortgage assets while suppressing discipline creates predictable insolvency and moral hazard.

5) Unifying Mechanisms (Across Cases)

- **Balance-sheet margins:**
 - Lower **Equity/Assets** and **Cash/Assets** when protected.
 - **Market-discipline margin:**
 - Guarantees mute **deposit flows** & **rate premia** as risk signals.
 - **Entry/strategy margin:**
 - Guarantees attract **new, riskier entrants** & incentivize **risk-shifting** by impaired incumbents.
 - **Political economy:**
 - Risk subsidies are **sticky** (constituencies form); prudential rules **bend** to keep subsidies valuable.
-

6) Policy Implications

- If the **goal** is affordability or access, prefer **transparent cash/on-budget subsidies** (or income-side tools) over **risk guarantees**.
 - If guarantees are used:
 - **Price** them (risk-based premia),
 - **Cap** exposure (coinsurance, deductibles),
 - **Enforce** tough, **countercyclical** capital/liquidity,
 - **Resolve** zombies early (no gamble-for-resurrection),
 - Preserve **information & market signals** (disclosure, credibly uninsured funding at the margin).
-

7) Key Ratios & Terms (quick reference)

- **Equity/Assets (E/A)** — solvency buffer (↑ = safer).
 - **Cash/Assets (C/A)** — liquidity buffer (↑ = safer).
 - **Loans/Assets (L/A)** — asset risk intensity (↑ = riskier, all else equal).
 - **REO/Assets** — foreclosure footprint (↑ = distress).
 - **Duration/IR risk** — value sensitivity to rate changes.
-

8) Discussion Prompts

- 1) When (if ever) are **risk subsidies** superior to **cash subsidies**?
 - 2) How would you design **deposit insurance** to preserve **discipline**?
 - 3) What early-warning metrics would you track to catch “**gambling for resurrection**”?
 - 4) Should a state **ever** subsidize 30-year fixed-rate mortgages directly?
-

