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Real Interest Rates and the Savings and Loan Crisis: The Moral Hazard Premium

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Abstract

Real interest rates shifted upwards by four or five percentage points in approximately 1980. The question is why. In this paper we review some of the more popular explanations and point out that they are somewhat inconsistent with the facts. We then present a new explanation which may partially account for the dramatic increase. We suggest that the upward shift in rates may be directly connected with the decade-long crisis in the savings and loan industry and the federal government's handling of that crisis. Owners and managers of troubled thrifts responded to the incentives provided by underpriced deposit insurance by offering higher and higher rates in an attempt to attract new funds. Depositors, anticipating that the government would protect their investments, actively sought out higher yields in local and national

markets. The end result was that the rates offered by Treasury securities rose to compete with these quasi-risk-free substitutes sold by savings and loans. This added (and, indeed, continues to add) significantly to the federal government's borrowing costs. We calculate this increased cost under various assumptions about the effect of the S&L crisis on real interest rates.

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