

Analysis of Bailouts

Definition of bailout

A bailout is the rescue of an economic entity (“the rescued entity”) from potential or actual insolvency, with the rescue performed by another economic entity (“the rescuer”). Generally, bailouts are ad hoc; but the EU has a formal bailout program, termed “Rescuing and Restructuring Firms in Difficulty.” In principle, either the rescuer or the rescued entity can be an individual, a company (either financial or nonfinancial), a government, or an international organization. The most common cases are a national government and/or central bank rescuing one or more domestic financial institutions, and an international organization (the International Monetary Fund, IMF) rescuing member governments.

Bailout policies

A variety of bailout policies have been used by rescuers. Perhaps the most common policies are direct loans or guarantees of third-party (private) loans to the rescued entity. The direct loans often are on terms favorable to the rescued entity. Direct subsidies can be provided to the rescued entity. Also, the government can purchase newly issued shares (possibly preferred stock) in the rescued entity. There can be strict requirements when the government recapitalizes firms, including some or all of no dividends, replacement of management, and restrictions on executive pay—in effect for a stipulated time period, until certain performance benchmarks are met, or until the government is repaid. Further, there can be temporary relaxation of regulations that restrict the accounting and/or the behavior of the rescued entity.

For banks specifically, there are more policy options. There can be expansion of existing government guarantees of deposits to higher, possibly even unlimited, amounts—or the creation of such guarantees. Additionally, bad loans or bad securities of financial institutions can be obtained by the government or a quasi-government agency, at higher than market prices, with disposal now the problem of the rescuer.

Advantages of bailouts

There are potential advantages to a bailout. The bailout assures continued survival of a rescued entity in the face of temporarily disadvantageous economic circumstances. It can avoid a collapse of the financial system by stemming a run on banks, whence the generation of the “too-big-to-fail” (TBTF) policy: the government will not permit the failure (insolvency) of institutions the size or functioning of which is crucial to the overall economy or to critical sectors of the economy.

As a form of insurance, an ex ante bailout can inhibit moral hazard. In fact, Jeanne and Zettelmeyer (2005) present a theoretical model which demonstrates that, under certain assumptions, anticipation of IMF lending to a member country moves the world closer to

a Pareto optimum. Absent the IMF, the discipline of the market on the domestic government is too high (from an efficiency standpoint). The Jeanne-Zettelmeyer result is at variance with the conventional wisdom about IMF rescue of member countries: “The prospect of future IMF bailouts allows investors to lend excessively to member countries at interest rates that do not adequately reflect underlying risks and encourages borrowers to behave in imprudent ways” (Lee and Shin, 2008, p. 816).

Disadvantages of bailouts

Disadvantages of bailouts fall into two categories: anticipated bailouts and actual bailouts. Anticipated bailouts encourage moral-hazard behavior not only by the rescued entity but also by entities (customers, lenders, borrowers, depositors) that engage in economic transactions with that entity. Expected rescued entities engage in excessive risk taking and become too large, both outcomes according to the criterion of economic efficiency. Ennis and Malik (2005) develop a theoretical model of the effect of TBTF policy on bank decision-making. The result is consistent with moral hazard: a known TBTF policy increases the probability of failure of the bank.

The Jeanne-Zettelmeyer model requires further discussion; for the result of no harmful moral hazard is unusually optimistic. Important assumptions for enhanced efficiency from an IMF-rescuer bailout of a member country are (1) the domestic government maximizes the welfare of a representative resident, and (2) the IMF charges an interest rate that just covers the risk it is assuming—no more and no less. Jeanne and Zettelmeyer argue, with some force, that empirically the IMF interest is “actuarially fair”: assumption (2) holds. However, considering assumption (1)—“that debtor country governments act in the best long-run interest of their taxpayers”—they admit that “one does not have to be a cynic to doubt that this is the case” (Jeanne and Zettelmeyer, 2005, p. 80). Also, and very important, it does not appear that the model can be extended to purely domestic situations, that is, anticipated national-government bailout of domestic firms.

When bailouts are not anticipated, the moral-hazard effect is for the future only—but it is only reasonable to surmise that it will be there. Putting moral hazard aside, even unanticipated bailouts have serious problems, at least at the individual-country level. First, economic efficiency is reduced, because weak firms are favored (in fact, saved), while actual or potential stronger firms are left out—to the detriment of economic efficiency. In this light, Rosas (2006, p. 175, n. 1) quotes Walter Bagehot as follows: “Any aid to a present bad bank is the surest mode of preventing the establishment of a future good bank.” In the same vein, Shiller (2008, p. 93) writes: “The use of bailouts may be compared to trying to halt a disease epidemic by lavishing emergency care on the sickest and those nearest to death.” Bailouts are the worst kind of triage, because the most inefficient. Bailouts go against market outcome in the most extreme way.

Second, there is a redistribution of wealth from taxpayers to the rescued institution and its creditors. To an objective observer, that redistribution is inequitable. It is hard to make an equity argument that the costs of the rescue should be borne by the general public rather

than by the shareholders and creditors of the rescued institution.

Third, it is not inevitable that the bailout will “work,” in the sense that the rescue of the institution will be anything but temporary. As Glowicka (2006) points out, to prevent a future failure, the rescue might have to be repeated. And even if the bailout “works” the first time, the inefficiencies are there. Perhaps the government has the foresight to see a great economic future for the rescued firm provided only that it is given temporary economic help (the bailout)—but then it is seeing something that “the market” does not. The similarity to an infant-industry tariff is obvious. Experience with infant-industry protection shows that often “market failure” is not present but “government failure” is created.

Fourth, even if the government carries out its role in the bailout, there is no guarantee that the rescued firm will do its part. For example, the government may provide capital for banks in difficulty; but the banks may hoard the funds rather than lend them out!

Alternatives to bailout

The first, and most obvious, alternative to a bailout is to avoid government intervention and “let the market work.” Let the mismanaged or weak institutions fail or be absorbed by stronger firms! Consistent with that prescription, Rosas (2006) points out that Bagehot advocated provision of central-bank liquidity to solvent banks and not to insolvent banks, thus permitting the weakest banks to fail. In general, by not intervening, government (1) allows economic agents to bear the consequences of their own actions and thus does not generate moral hazard, (2) avoids putting taxpayer money at risk, and (3) strengthens the sector of the economy in which the non-rescued firm is situated. According to this strict market-oriented alternative, in the United States, the insolvent firm would be subject to “Chapter 7 bankruptcy” and be liquidated. A similar situation exists in other countries. Instead, the failing firm could merge with, sell its assets to, or be taken over by another firm. This outcome is consistent with the market, providing the government does not assist the merger by bailout policies.

A second alternative is to undertake general macroeconomic policies. As Laeven and Valencia (2008) observe, inflation and currency depreciation are tried-and-true mechanisms by which debtors can be relieved. While it would be unwise to use macroeconomic policies for other than standard macroeconomic goals, at least in principle such policies are non-discriminatory. Under a systemic crisis, conventional macroeconomic policies should be tried before any bailout. Even if a bailout is adopted, it should be supplemented by such policies.

A third alternative is available in the United States as “Chapter 11 bankruptcy” and in some other countries by other name. The firm loses some autonomy but remains in existence. The great advantage to this alternative, as noted by Glowicka (2006), is that the firm has an incentive to graduate from bankruptcy protection; because the bankruptcy is costly to the firm (direct costs of legal and other services, loss of customers, unfavorable terms of suppliers, etc.). Another advantage is that taxpayers bear no cost.

Empirical evidence

Only a few empirical studies of bailouts are discussed here, and those related to the IMF are excluded. Faccio, Masulis, and McConnell (2006) use data from 35 countries over 1997-2002 to show that politically connected firms are more likely to be rescued than their “nonconnected peers.” Further, they find that the former firms exhibit worse operating performance than the latter, both at the time of the bailout and subsequently. Rosas (2006) analyzes 46 banking crises in 38 countries over 1980-1994 and concludes that the “bailout propensity of governments” is limited by transparency and by central-bank independence. Glowicka (2006) studies EU bailouts of 79 firms over 1992-2003 and finds that “the probability of exit [the firm failing] increases in the first four years [after the bailout].” In contrast, other studies show that “the estimated probability of leaving Chapter 11 as a vital business increases with time” (Glowicka, 2006, p. 23). In sum, the empirical evidence suggests that it would be wise for governments to avoid bailouts and use alternative policy.