

For Us or For Them? Bailouts Then and Now

By Robert E. Wright



SHOULD THE U.S. GOVERNMENT, or any government for that matter, use public money to stabilize a disintegrating financial system? Theory backed by historical experience suggests that it should, but only if it does so in just the right way. Financial crises are best avoided as they can have significant negative effects on economic and political systems, not to mention people's lives. Once a crisis is underway, however, government inaction may be better than implementing a bailout hastily cobbled together by politicians and bureaucrats who are anxious to keep their jobs. Bailouts are heterogeneous and differ significantly in their effects. At their best, they ameliorate panic conditions and reduce human suffering, but at their

worst they redistribute wealth from taxpayers to the individuals and institutions most responsible for the crisis and even increase the likelihood of future financial fiascos.

As Table 1 details, the economic impact of U.S. financial crises since 1763 has ranged from mild to traumatic. Real per capita incomes actually rose in the wake of the 1792 panic and shrank only briefly and modestly following the crises of 1818–1819, 1990–1991 and 2000–2001. The Panic of 1873, by contrast, led to six long years of recession, and the financial crises of the 1890s and 1930s spawned depressions long and steep. Financial crises have also created nasty political fallout ranging from major regulatory reforms (1907,

1929–1933, 1990–1991, 2000–2001) to political party realignments (1818–1819, 1857, 1873, 1893–1895) to rebellion and revolution (1764, and almost in the 1930s according to some). Depressing as it is, Table 1 does nothing to capture the horrific human suffering the crises engendered, including the urban riots of 1819, the dispossessed farmers of 1893, the bread lines of 1933 or the subprime despair of 2007–2008.

The distressing length of Table 1 may suggest to some that financial crises are the inevitable byproducts of financial innovation, periodic costs that the economy must suffer to pay for dynamic growth. Although the complete elimination of financial crises is unlikely, the long periods of pros-

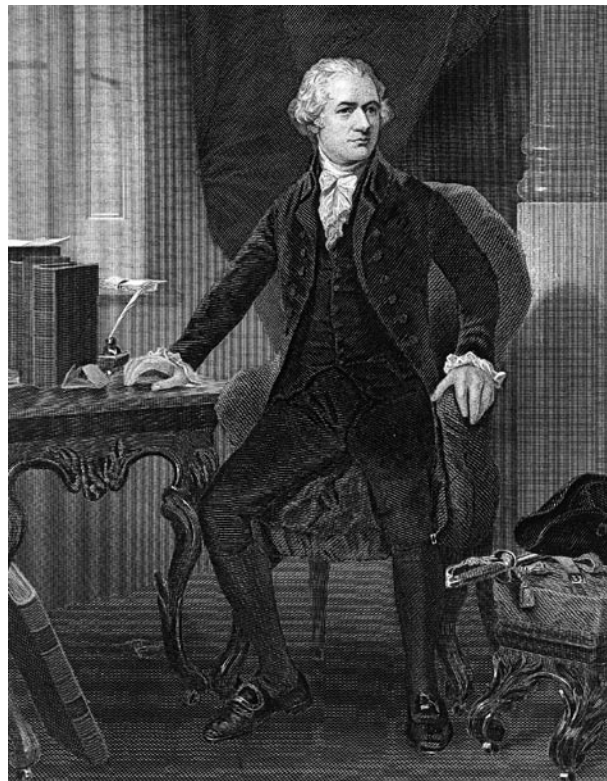
Table 1 The Economic and Political Consequences of Major U.S. Financial Panics, 1763–2008

Crisis Year(s)	Causes	Recession Years	Real per capita GDP High (2000 USD)	Real per capita GDP Low (2000 USD)	Percentage Decline (%)	Effects
1764–65	Real estate	1764–1768	n/a	n/a	50% (land prices)	Imperial Crisis and Revolution
1792	Public securities, bank stock	n/a	\$943 (1791)	\$1,030 (1793)	n/a	Hamiltonian financial program continues to develop
1818–19	Real estate, commodities, imports, turnpikes	1819–1820	\$1,330	\$1,315	1	Realignment of the Jacksonian Party; destruction of the Second Bank of the United States
1837–39	Real estate; agriculture; canals	1837–43	\$1,681	\$1,618	4	Wave of state constitutional reforms
1857	Grain; gold	1857–58	\$2,252	\$2,202	2	Republican party solidification and increased sectional animosity
1873	Railroad securities; real estate	1873–1879	\$2,834	\$2,737	3	Rise of labor unions and agrarian reform groups
1893–95	Railroad and other equities	1893–1897	\$4,559	\$3,913	14	Populism; Progressivism; Great Merger Movement
1907	Equities	1907–8	\$5,621	\$4,917	12.5	Federal Reserve System
1929–33	Equities; banks; real estate	1929–1933	\$7,099	\$5,056	29	RFC (1932); FDIC (1933); SEC (1933); SSA (1935)
1980s	Savings and Loans; real estate	1980–82 1990–91	\$23,007 \$28,429	\$22,346 \$28,007	3 1.5	FIRREA and RTC (1989); Riegle-Neal (1994)
2000–1	Equities; corporate accounting	2001	\$34,759	\$34,659	.02	Sarbanes-Oxley (2002)
2007–?	Real estate; subprime mortgages; derivatives	2008–?	\$38,148	\$TBD	TBD	Emergency Economic Stabilization Act (2008); TBD

perity and financial calm that followed the Panic of 1792 and World War II suggest that the tradeoff between crisis and growth, between systemic risk and aggregate output, may not be as stark as some believe. Improved public policies, in other words, may be able to decrease the number and severity of financial crises in the future. In order to affect that happy end, however, policymakers must develop better theories of why crises occur.

Financial crises are just one of many hyper-dysfunctional or “FUBAR” (Fouled Up Beyond All Recognition) aspects of the economy. Other examples include construction, health insurance and health care, higher education, marriage, mortgages, retirement savings and other lagging sectors where costs increase faster than inflation and quality stagnates or even degrades. Those on the Left tend to trace hyper-dysfunction to market failures like asymmetric information (e.g., adverse selection, moral hazard), asset bubbles (e.g., housing prices in the 1760s, 1920s, and 2000s), externalities (negative like pollution and positive like education) and public goods (e.g., national defense, funding for basic scientific research). Those on the Right, by contrast, typically find fault with the government, particularly the lack of bureaucratic accountability and the futility of central planning.

Explanations of the subprime mortgage crisis of 2007 and the great crash of 2008 follow that same predictable pattern. Democrats usually blame the crises on unscrupulous and manipulative financiers who by hook and by crook tricked the government into repealing crucial financial regulations and modifying important accounting rules. Republicans typically argue that the government caused the crisis by keeping interest rates too low for too



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Secretary of the Treasury Alexander Hamilton implemented “Hamilton’s Rule” in response to the Panic of 1792.

long, by pushing lenders into making risky loans to low-income borrowers, and by reducing the effectiveness of private monitoring by foisting weak public substitutes like the Securities and Exchange Commission on unsuspecting investors.

Both sides are partially correct but they miss the essence of the problem – that market and government failures *combined in complex ways over long periods of time* to cause the crash. The failures were hybrids, partly government and partly market in origin; many of them were put into motion decades ago. The mortgage interest deduction, for example, is as old as the modern U.S. income tax system itself. The deduction’s distortion of savings decisions (away from building home equity and toward investment in securities markets) grew along with rising marginal tax rates, the advent of home equity lines of credit and easy refinancing terms, and tax preferences for 401K and similar retirement plans. The government basically paid people to mortgage their homes to the hilt

and invest in the stock market so it isn’t surprising that many did so, with plenty of help from financial institutions eager to win their business.

Ill-conceived compensation structures were another type of hybrid failure that fed the financial crisis. Between the Civil War and World War II, six U.S. mortgage securitization schemes failed because mortgage originators received their full commissions at closing, which rewarded them for authorizing loans to anyone and everyone rather than for screening the level of risk. Life insurance regulators squelched an analogous problem by mandating that agents’ commissions be spread over five or more years. Despite those clues, regulators allowed the mortgage misalignment to recur in the Third Millennium. They also allowed

investment banking partnerships to go public without considering the crucial role that ownership structure plays in managerial risk-taking. Partners’ wealth was mostly tied up in their firms, so they were inherently more risk averse than were mere managers compensated largely on the basis of short-term and often illusory accounting gains. Especially in the wake of Enron’s failure, regulators should have realized that the temptation to generate the appearance of short-term profits, which is easily done via any number of accounting techniques, would prove too strong for many managers to resist given the immense size of the annual bonuses at stake.

Government-sponsored enterprises (GSEs) are another obvious example of hybrid failure. Founded as a government agency in 1938, the Federal National Mortgage Association (Fannie Mae) for three decades provided liquidity to mortgage lenders by buying their safe mortgages, then securitizing and selling them to investors. The

Table 2 The Consequences of Different Types of Government Bailouts

Reaction	Risk	Profits	Examples
1a. do nothing — won't	Not socialized: government does not feel that it is appropriate or prudent to do so.	Private	<ul style="list-style-type: none"> • Enron, 2001 • Superior Bank, 2001 • Lehman Brothers, 2008
1b. do nothing — can't	Not socialized: government is unable to do so for ideological and/or institutional reasons.	Private	<ul style="list-style-type: none"> • Banking crises in 1819, 1837–39, 1857, 1873, 1884, 1893–93
2. broker a private rescue	Not socialized: government uses its power to induce private parties to aid troubled companies.	Private	<ul style="list-style-type: none"> • J.P. Morgan, 1907 • National Credit Corporation, 1931 • LTCM, 1998
3. favoritism	Not socialized: government endows troubled companies with a competitive advantage such as a protective tariff or regulatory forbearance.	Private	<ul style="list-style-type: none"> • Bank holiday of 1933 • Life insurer forbearance, 1930s • Savings and Loan Crisis, Phase 1 • Steel tariffs, 2002
4. cash grants	Socialized: government directly subsidizes distressed entities with cash.	Private	<ul style="list-style-type: none"> • Airline industry, 2001 • merger sweetener (cash to acquirer) • payoff (cash to uninsured creditors)
5. loan guarantees	Socialized: government guarantees the debts of troubled companies.	Depends on details	<ul style="list-style-type: none"> • Lockheed, 1971 • Chrysler, 1979 • GSEs
6a. lender of last resort—modern central bank rule	Socialized: government loans to distressed companies and industries with indifferent collateral at a subsidized rate.	Mostly private	<ul style="list-style-type: none"> • Stock market crash, 1987 • Currency and sovereign default crisis, 1997–98 • Y2K, dotcom bubble burst, 9/11, 1999–2002 • Subprime mortgage crisis, 2007
6b. lender of last resort — Hamilton nee Bagehot's Rule	Socialized: government loans to distressed companies on good collateral at a penalty rate.	Mostly public	<ul style="list-style-type: none"> • Panic of 1792 • Reconstruction Finance Corporation, Phase 1
7. troubled asset purchases	Socialized: government purchases the troubled or illiquid assets of distressed companies	Private/public	<ul style="list-style-type: none"> • FDIC assumption of bad bank debts • TARP, Phase 1
8. equity investor of last resort (partial nationalization)	Socialized: government purchases equity stakes in distressed companies.	Private/public	<ul style="list-style-type: none"> • Reconstruction Finance Corporation, Phase 2 • Continental Illinois, 1984 • TARP, Phase 2
9. conservatorship	Socialized: government owns bankrupt companies with the intent of winding down their operations and selling their assets in a controlled fashion.	Public	<ul style="list-style-type: none"> • Bridge banks, e.g. First Republic Bank of Texas, 1988 • Resolution Trust Corporation, 1989 • Fannie Mae and Freddie Mac, 2008
10. full nationalization	Socialized: government owns troubled companies with the intent of owning and operating them, though it may privatize them later.	Public	<ul style="list-style-type: none"> • Conrail, 1976–1987 • Amtrak, 1971–ongoing

system worked well, but in 1968 the government decided to get Fannie off its balance sheet because it was under pressure from the budget deficits associated with the Vietnam War and President Lyndon B. Johnson's "Great Society" programs. Two years later, the government created a second publicly-traded company, the Federal Home Loan Mortgage Corporation (Freddie

Mac), to compete with it. The pair were tagged GSEs because the government implicitly guaranteed their debts, a lucrative arrangement that allowed them to borrow much more cheaply than other corporations could.

The GSEs were also allowed to maintain a leverage ratio of 40 to 1 (\$40 in assets for every \$1 in capital), an extremely aggressive level envied

even by hedge fund managers. The GSEs were therefore extremely profitable and hence powerful forces in Washington, which generally couldn't get out of their way fast enough. The biggest irony of the 2007–2008 crisis was that the very institutions most clearly backed by the full faith of the U.S. government were among the

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least-monitored in the whole system. Regulators could not chastise them without fear of political reprisal and their bondholders, lulled to sleep by the government guarantees, had little incentive to pry. It was no accident that the GSEs invested heavily in subprime mortgages and other risky assets.

The complexity and mammoth size of many financial institutions today is also no accident, but rather the direct result of the confluence of specific market forces and governmental incentives. With the advent of Too Big to Fail (TBTF) policy in the mid-1980s, a free insurance scheme for the nation's biggest financial institutions, the government actually encouraged large size and complexity. Regulators believed, mistakenly as it turned out, that bigger was sounder. They learned from the Great Depression and the Savings and Loan Crisis that small banks are fragile. Unit banks (branchless banks) have a difficult time diversifying their loan portfolios sufficiently to withstand economic shocks and regulators must constrain small institutions from investing in asset classes, like securitizations and other derivatives, which their managers usually do not fully comprehend. It does not follow, however, that because small banks are risky, large banks are safe. Big bankers are imperfect beings too, and as discussed above often personally benefit from making large bets with what is essentially taxpayer money.

To reduce the chances of a recurrence and to mitigate the effects of any future panic, policymakers should undertake non-partisan reforms that directly address the hybrid nature of the failures that led to the crash. The government could start by eliminating tax incentives to invest in the stock market instead of in homes. It could also encourage companies to devise deferred compensation structures, especially in long-term financial

businesses like mortgages. Fannie and Freddie, already in conservatorship, should be wound down completely or re-nationalized so that socialized risks will also lead to socialized profits. Similarly, the government should charge the market price for guaranteeing the liabilities of companies that its deems are too big or complex to fail.

Of course even those reforms may prove insufficient to prevent all future crises. The government should therefore devote some resources to improving its crisis response. History can provide important guidance again here. Econometric evidence suggests that over recent decades, bailouts both at home and abroad have not sped economic recovery on average. In the more distant past, however, some bailouts succeeded admirably without unduly taxing innocent bystanders or encouraging further risk-taking (increasing moral hazard in the parlance of economists). The key appears to be the type of bailout implemented.

Table 2 lists major types of government bailouts. Those that socialize risk while allowing private entities to profit (e.g., 6a) are objectionable on economic as well as moral, re-distributional grounds. Such bailouts may re-capitalize battered financial firms, but they are equally likely to impose large costs on taxpayers with little in the way of corresponding benefit. The best types of bailouts are those, like Hamilton's Rule (6b), that socialize profits as well as risks. They are fairer for taxpayers and hence more politically palatable and also much less likely to foment future risk-taking and recurring crises.

First implemented by Treasury Secretary Alexander Hamilton in response to the Panic of 1792, Hamilton's Rule holds that the lender of last resort should lend freely but at a penalty rate to all who can post sufficient collateral. The rule allows the lender of last resort (the Bank of the United States then and the Fed today) to save safe companies facing temporary liquidity restraints but

chastens them with relatively high rates. It also allows risky companies to fail in droves. That sounds negative, but in fact is palliative because it quickly exorcises the financial system of its demons. The rule worked perfectly in 1792; the panic ended quickly and was not followed by recession. Perhaps more importantly, the U.S. financial system did not suffer another nationwide peacetime financial panic until 1819.

The same could not be said for the modern central banking rule (6a) used repeatedly by Federal Reserve Chairman Alan Greenspan. Each time that the Fed interceded, risk-taking market participants were rewarded because whenever trouble struck (e.g., the 1987 stock market crash, the failure of Long Term Capital Management, the dotcom bust), the Fed lowered interest rates and flooded banks with money. Unsurprisingly, the crises grew progressively larger until they almost ruined the global financial system and world economy in September 2008. The Fed again prevented a complete meltdown, but in the process it planted the seeds of future crisis. Whether those seeds will again grow to bear the bitter fruit of financial panic and economic despair depends largely on how reforms, including those currently under consideration in Congress, influence risk-takers' expectations of the size and nature of future bailouts. The more Hamiltonian those reforms are, the better off taxpayers and the economy will be. ■■

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